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Office of Tax Policy Analysis

REPORT TO THE GOVERNOR AND LEGISLATURE

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State Tax on Motor Vehicle Damage Awards

Evaluating the impact and cost-effectiveness of Article 15

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Background

New York State enacted Article 15 of the Tax Law in 1991 to address what some perceived as major sales tax compliance problems in the motor vehicle repair industry. Subsequent litigation and amendments contained in the 1995-96 State budget postponed implementation of the tax until September 1, 1996. The budget legislation also directed the Department of Taxation and Finance, with the Insurance Department and the Department of Motor Vehicles, to conduct this study of the tax.

Insurance Department regulations require that motor vehicle damage awards include the sales tax due on the vehicle's repair or replacement. Implementation of Article 15 would substantially change that. The tax provides that, in lieu of an upfront payment with the damage award, the insurer would withhold the tax component of the award. The insurer would then remit the withheld tax to the State and issue a voucher to the claimant. The claimant could use the voucher in place of paying the sales tax when he or she repairs or replaces the vehicle.

The legislation's sponsors intended the tax to improve sales tax compliance in the repair industry and to decrease opportunities for insurance fraud. Our analysis indicates that the tax will be ineffective in both regards.

The tax will not prove economically efficient.
For every dollar of State and local revenue the tax raises, Article 15 will cost government, industry and consumers more than $6 to comply with and administer.

Sales tax compliance does not appear to be exceptionally poor in the motor vehicle repair industry. Audit results indicate that repair businesses may even be slightly more compliant than comparably sized businesses in other industries.

The tax will fail to address insurance fraud problems.
Rather than fighting insurance fraud, the tax will give the State a piece of the action when motorists fraudulently inflate their vehicle repair costs.

Results in Brief

On average, businesses in the repair industry underreported taxable sales by 14.3 percent. Comparably sized businesses in other industries underreported by 14.9 percent.

The tax will raise $9 million in State and local revenue. However, compliance and administrative costs will total more than $61 million.

Repair shops will be able to easily circumvent the Article 15 system. In fact, some businesses could actually use the system to increase tax evasion.

There are several more effective and less costly means of improving compliance in the repair industry.

Recommendation

The State should repeal the Article 15 tax. In its place, tax administrators should explore less intrusive and less costly enforcement measures.

Background

The tax would significantly change how the State taxes motor vehicle repair services

New York State enacted Article 15 of the Tax Law in 1991 to address perceived sales tax compliance problems in the motor vehicle repair industry.[1] The sales tax applies to motor vehicle repair services. Article 15's proponents believed that repair shops, which collect sales tax, did not remit all of the tax money to the State.[2] The Article 15 tax, if implemented, would significantly change how the State taxes motor vehicle repair services and purchases of replacement vehicles. Subsequent litigation and amendments contained in the 1995-96 State budget delayed implementation of the tax until September 1, 1996.

Article 15 Overview

Currently, when an insurance company pays a motor vehicle claim, it includes money to reimburse the motorist for the sales tax on the repair or replacement of the damaged vehicle.[3] If the motorist has the car repaired, he or she pays the sales tax to the repair shop. If the motorist replaces the vehicle, he or she pays the sales tax to the dealer.[4]

Insurers would provide motorists with a voucher to use in lieu of paying the sales tax on repairs

Under Article 15, the insurance company would continue paying the motorist money for repairs or a replacement. However, the payment would not include sales tax. The insurance company would withhold a tax component of the damage claim and remit it to the State as a separate tax. The motorist would receive a credit voucher equal to the amount of Article 15 tax withheld.[5]

The Article 15 legislation provides that insurance companies must produce vouchers that are counterfeit-proof, serially numbered and non-transferable. The vouchers also must contain information regarding the issuing insurer; the date of issuance; the claimant's name, address and county of residence; the claimant's federal identification number or social security number; and the vehicle identification number, year, make and license plate number of the damaged motor vehicle.

Under Article 15, instead of paying sales tax on the vehicle's repair or replacement, motorists would present the voucher to the repair shop or dealer.[6] The sales tax vendor— usually a repair shop— would keep the voucher until filing a quarterly sales tax return. At that time, the vendor would send part of the voucher to the State and claim a credit against any sales tax liability for repair services covered by vouchers.[7]

Motorists certifying that they are not going to repair or replace their damaged vehicles within one year could apply to the Department for a refund of the Article 15 tax withheld. Also, motorists repairing their vehicles outside New York could apply to the Department for a refund of any sales tax paid to the other state.

In any other case, the State would retain the entire withheld tax. Moreover, the State would retain, from redeemed vouchers, the excess of the withheld tax over the actual credited sales tax. For example, if the sales tax on the actual repair was less than the amount the insurer withheld on the insurance award, the State would retain the difference. (Appendix A describes the Article 15 system in more detail.)

Figure 1 compares the current sales tax to Article 15 for a typical automobile insurance claim. The illustration assumes the individual incurred $1,000 in damages to his or her vehicle and the combined State and local sales tax rate in the locality where the individual resides equals 7 percent.

Figure 1: Comparison of a Typical Repair Transaction Under the Sales Tax and Under Article 15

Sales Tax (Current Law)	Article 15 System
Claimant submits claim for $1,000 in damages to insurance company.	Claimant submits claim for $1,000 in damages to insurance company.
Insurance company sends the claimant a check for $1,070 ($1,000 for the repair work and $70 for the sales tax on the repair).	Insurance company sends the claimant a check for $1,000 and an Article 15 voucher with a face value of $70.
	The insurance company remits the $70 in withheld tax to the State (usually on a monthly basis).
When the repair is completed, the claimant pays the repair shop $1,070 ($1,000 for the repair work and $70 in sales tax).	When the repair is completed, the claimant pays the repair shop $1,000 for the repair work. The claimant also presents the $70 voucher to the repair shop in lieu of paying the sales tax.
The repair shop reports the $1,000 taxable sale to the State and remits the $70 in sales tax (usually on a monthly or quarterly basis).	The repair shop reports the $1,000 taxable sale to the State. It also sends the voucher to the State and claims a $70 credit against the sales taxes it remits.

Insurance Industry Challenges

The insurance industry strongly opposed Article 15. On August 29, 1991, three days before the legislation's scheduled effective date, a consortium of insurance companies obtained a temporary restraining order prohibiting the State from implementing the new law. The industry also commenced an action seeking a permanent injunction against the legislation.[8] A subsequent Appellate Court decision cleared the way for the State to enact the tax.[9] However, that decision is currently under appeal. (For a summary of the Article 15 litigation see Appendix B.)

The Appellate Division decision would allow the State to implement Article 15. However, it could also affect how the State would administer the tax. In its decision of December 27, 1994, the Appellate Division found that the Article 15 tax is essentially a prepayment of sales tax, rather than a new and separate tax. As a result of that interpretation, Article 28 sales tax rules, including sales tax refund provisions, would apply to Article 15.

The insurance industry appealed the Appellate Division decision. On February 10, 1995, the Attorney General, upon advice of the Governor's Office, agreed to continue the stay of Article 15 while the plaintiffs sought leave to appeal to the Court of Appeals.[10] The Court of Appeals scheduled oral argument for the appeal on April 30, 1996.

Throughout this report, all analysis pertains to the provisions provided for in the original 1991 legislation. That is, our analysis does not reflect the Appellate Division's view of the tax as a form of prepaid sales tax. Rather, it reflects the view that the Article 15 tax is a separate tax on the transfer of insurance damage awards. If the State administered the tax as a prepaid sales tax, many aspects of the tax, particularly the refund provisions, would be significantly different. In most instances, application of the sales tax rules would make Article 15 more complicated and more costly.

Study Mandate

In his proposed 1995-96 Executive Budget, Governor Pataki called for repeal of Article 15. However, as enacted, the budget legislation left Article 15 in place with its implementation date delayed until September 1, 1996. The budget legislation also provided that the Department of Taxation and Finance, with the Insurance Department and the Department of Motor Vehicles, conduct this comprehensive study. Appendix C contains a full description of the legislative mandate.

The mandate required the Department to consult with industry and consumer representatives. To reflect their views, the Department formed an advisory panel. Representatives of the insurance industry, the motor vehicle repair industry, consumers and affected State agencies comprise the panel. Appendix D provides a list of the advisory panel members.

The study addresses several key questions including:

- How pervasive is sales tax evasion in the motor vehicle repair industry?
- Is Article 15 an economically efficient means of addressing compliance problems?
- Are there alternatives that should be considered?

Findings

Industry Profile

Sales tax records for the 1994 sales tax year[11] indicate that 17,829 registered vendors are vehicle repair businesses. Those vendors reported taxable sales totaling nearly $2.4 billion and remitted State sales taxes totaling $94.4 million.

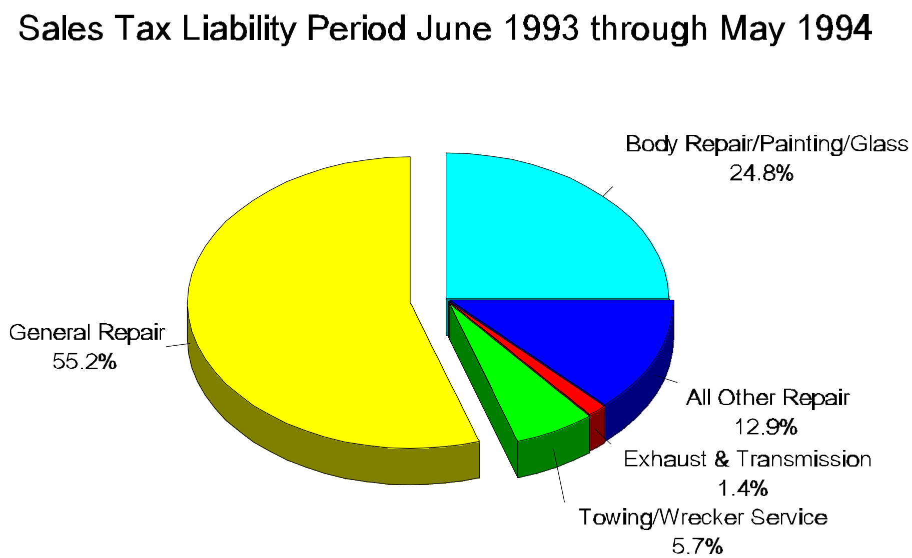
Table 1 provides a profile of the repair businesses.[12] The table shows that, within the repair industry, the largest category of businesses was general repair. There were 9,767 vendors in that category, representing 55 percent of the entire population of vehicle repair businesses. The next largest category was body repair and painting businesses. There were 4,183 registered businesses in that category representing 24 percent of vehicle repair businesses. Together with auto glass businesses, that group represents the businesses most affected by Article 15.

Table 1: Profile of Vehicle Repair Service Vendors
Sales Tax Liability Period June 1993 through May 1994

Industry Group	Number of Registered Vendors	Percent of Vehicle Repair Service Vendors	Reported Taxable Sales ($000)	Average Reported Taxable Sales	State Sales Tax Liability ($000)	Average State Sales Tax Liability	Percent of State Sales Tax Liability
Body & Glass Repair Services	4,401	24.7%	$583,277	$132,533	$23,332	$5,302	24.8%
Body Repair and Painting	4,183	23.5%	565,239	135,128	22,610	5,405	24.0%
Glass Repair	218	1.2%	18,038	82,743	722	3,312	0.8%
Related Services	13,428	75.3%	$1,776,233	$132,278	$71,049	$5,291	75.2%
General Repair	9,767	54.8%	1,305,853	133,701	52,234	5,348	55.2%
Towing/Wrecker Services	1,760	9.9%	134,322	76,319	5,373	3,053	5.7%
Tire Retreading & Repair	321	1.8%	43,024	134,031	1,721	5,361	1.8%
Exhaust Systems	97	0.5%	16,372	168,784	655	6,753	0.7%
Transmission Services	200	1.1%	15,932	79,660	637	3,185	0.7%
Vehicle Repair Not Elsewhere Classified	1,283	7.2%	260,730	203,219	10,429	8,129	11.1%
New York State Total	17,829	100.0%	$2,359,510	$132,341	$94,381	$5,294	100.0%

Table 1 and Figure 2 also show the distribution of sales tax liability within the industry.[13] The distribution of sales tax liability is very similar to the distribution of vendors. The general repair group generated the largest percentage of sales tax liability. That group remitted 55 percent of the sales tax liability reported by the industry. Body repair and painting was the second largest category in terms of sales tax liability. That group remitted 24 percent of the sales taxes collected from the industry.

Figure 2: Profile of Repair Service Vendors - Based on Reported Sales Tax Liability



The repair industry remits 1.6 percent of the total State sales tax

To provide some perspective regarding the relative size of this industry, Table 2 compares sales tax information for the repair industry to statistics for other industry groups. As the table shows, the repair industry remits a relatively small share of the State's total sales tax. In the sales tax year examined, the repair industry remitted 1.6 percent of the total State sales tax.

Table 2: Comparison of Vehicle Repair Service Vendors to Other Vendors
Sales Tax Liability Period June 1993 through May 1994

	Number of Registered Vendors	Percent of All Registered Vendors	Reported Taxable Sales ($000)	Average Reported Taxable Sales	State Sales Tax Liability ($000)	Average State Sales Tax Liability	Percent of All Vendors State Sales Tax Liability
Vehicle Repair Service	17,829	2.9%	$2,359,510	$132,341	94,381	5,294	1.6%
Construction	46,826	7.5%	2,757,553	58,889	110,302	2,356	1.9%
Manufacturing	36,345	5.8%	6,834,505	188,045	273,380	7,522	4.6%
Wholesale Trade	46,285	7.4%	9,143,267	197,543	365,731	7,902	6.2%
Retail Trade	273,818	43.9%	82,129,411	299,942	3,285,176	11,998	55.4%
Services (Other than Vehicle Repair)	134,448	21.5%	18,838,960	140,121	753,558	5,605	12.7%
All Other	68,714	11.0%	26,089,336	379,680	1,043,573	15,187	17.6%
Grand Total All Industries	624,265	100.0%	148,152,542	237,323	5,926,102	9,493	100.0%

Sales Tax Compliance in the Repair Industry

Certain characteristics are common among industries displaying sales tax noncompliance.[14] Those characteristics include a high percentage of small businesses and a high percentage of cash sales. Since the repair industry displays many of these characteristics, there is undoubtably noncompliance in the industry. However, the more pertinent issue, for purposes of analyzing Article 15, is whether voluntary compliance in the repair industry is so poor that the benefits of revising the tax collection system outweigh its costs.

Noncompliance among repair shops may be no worse than for comparable businesses

We examined several methods of determining the extent of sales tax compliance problems in the industry. Some methods attempted to determine if many vehicle repair businesses fail to register as sales tax vendors. Other methods helped to evaluate the extent of compliance problems among registered sales tax vendors. None of the research methods indicated that sales tax noncompliance for businesses in the industry is significantly worse than for similarly sized businesses in other industries. Appendix E discusses the analysis in more detail.

Analysis of Special Audit Programs

The Tax Department has conducted two special audit programs whose findings are useful for purposes of the Article 15 analysis.

The first program identified businesses registered with the Department of Motor Vehicles (DMV) as motor vehicle repair shops but not registered as sales tax vendors. The program compared approximately 25,000 motor vehicle repair shops licensed by DMV with the population of sales tax vendors.[15] Ultimately, the program identified only 58 DMV registered repair shops, out of the population of 25,000, that had not registered as sales tax vendors. This percentage of unregistered vendors (0.24 percent) indicates that failure to register as a sales tax vendor is not a significant problem among the population of businesses that register with DMV as repair shops.

Businesses or individuals that repair vehicles, and that fail to register with either agency, may present a more significant problem. In the most recent year for which data are available,[16] DMV discovered 1,093 unregistered businesses providing vehicle repair services. Many unregistered businesses DMV finds are individuals employed in the industry that "moonlight" by repairing vehicles in their own garages.

A second special audit program involved the use of third-party records. We believe we can effectively use the sales records of wholesale parts businesses to identify retail businesses that are noncompliant. Unfortunately, because the program is still in its initial stages, its results are not yet available.[17]

Analysis of Audits

Auditing of taxpayer returns at the vendors' places of business (field audits) represents one of the Tax Department's primary sales tax compliance activities. We examined the three most recent years' sales tax field audit results for an indication of the extent of sales tax noncompliance in the automotive repair industry.

For many reasons, detailed in Appendix E, we could not extrapolate the audit results to the industry at large. However, the analysis provides some insight into the extent of noncompliance for audited vendors.

Table 3 shows the annualized results of field audits of vehicle repair vendors from State Fiscal Year 1992-93 through State Fiscal Year 1994-95. Auditors found that, on average, businesses in the industry underreported taxable sales by $42,758 or 14.3 percent of reported taxable sales. The average State tax assessment, before penalties and interest, equaled $1,710.[18]

To put these results in some perspective, the Department also examined the average audit results for a group of similarly sized businesses in other industries over the same time period.[19] Table 3 also exhibits the results of that analysis. As the table shows, the comparable group underreported taxable sales by $51,833 or 14.9 percent of reported taxable sales. The average State audit assessment for the comparable group equaled $2,075.

Table 3: Comparison of Audit Returns - Repair Service Vendors and Comparable Firms - State Fiscal Years Ending 1993-1995

	Avg. Reported Taxable Sales	Avg. Taxable Sales After Audit	Avg. Change in Taxable Sales	Avg. State SalesTax Increase	Avg. % Change in Sales Tax
Repair Services	$299,942	$342,700	$42,758	$1,710	14.3%
Comparably Sized Businesses	$347,868	$399,751	$51,883	$2,075	14.9%

Among audited businesses, sales tax compliance for businesses in the vehicle repair industry does not appear significantly different than for similarly sized businesses in other industries. In fact, it is slightly better.

Potential Revenue Gain from Article 15

The potential State and local revenue gain from enacting Article 15, before considering offsetting costs, is approximately $9 million. Table 4 summarizes the calculation of the revenue the State and localities may gain if the State implements Article 15. The revenue estimate presumes that claimants and vendors will comply with the terms and conditions of Article 15. To the extent that claimants and vendors abuse provisions of Article 15, the revenue potential would decline. Appendix F discusses the assumptions the Department used in making the calculation.

Table 4: Calculation of Potential State and Local Revenue from Implementing Article 15

Calculation of Article 15 Withholding		
1994 Automobile Physical Damage Claims Paid to NY Claimants		$2,320,044,254
Estimated Amount of Deductibles on Collision Claims	+	$270,235,800
Estimated Amount of Claims Paid to Tax Exempt Organizations	—	$132,622,339
Estimated Sales Tax Component on 1994 Claims	—	$178,406,138
Estimated Amount of Claims Paid for Reimbursement of Claims	—	$ 56,981,289
Estimated 1994 Article 15 Base	=	$2,222,270,288
Weighted Average State and Local Tax Rate	X	7.8274%
Estimated Article 15 Tax Withheld and Remitted to the State	=	$ 173,945,985
Calculation of Potential Revenue Gain From Article 15		
Estimated Article 15 Tax Withheld and Remitted to the State		$ 173,945,985
Adjustment for State and Local Sales Tax Currently Collected on Insurance Related Motor Vehicle Repair Services	—	$103,851,641
Adjustment for State and Local Sales Tax on Claims Where the Claimant Purchases or Leases a New Vehicle	—	$ 34,789,197
Adjustment for Claims Where the Repair is Made Outside the State and the State Refunds Part of the Voucher Amount	—	$ 8,697,299
Adjustment for Claims Where the Claimant Does Not Repair the Vehicle and the State Refunds the Entire Voucher Amount	—	$ 17,394,598
Potential State and Local Revenue from Implementing Article 15	=	$ 9,213,249
State Portion of Revenue Gain		$ 4,698,757
Local Portion of Revenue Gain		$ 4,514,492

Estimate of Article 15 Tax Withholding

The first step in the calculation of the revenue gain was estimating the total Article 15 tax insurers will withhold and remit to the State. We based that estimate on the amount of physical damage claims insurers paid to New York residents and businesses. We then adjusted the total claims figures to account for a number of factors. Finally, total claims, after the adjustments, was multiplied by a weighted average State and local tax rate. Based on these calculations, we estimated that insurance companies will withhold and remit to the State approximately $174 million in Article 15 tax. The following describes the calculation in more detail.

Damage Award Claims - The revenue estimate is based on the amount of physical damage claims insurance companies paid to New York claimants. Insurance Department data indicate that, in the 1994 calendar year, insurance companies paid $2.32 billion in physical damage claims to New York claimants.[20]

Adjustment for Policy Deductibles - The Insurance Department's claims data reflected only claims paid by insurance companies. It did not include the policy deductibles that claimants paid. However, the base of the Article 15 tax is the amount of claims plus the amount of deductibles claimants pay. We estimated the total value of the deductibles and added that figure to the Article 15 base. The adjustment for deductibles totaled $270.2 million.

Adjustment for Tax Exempt Repair Services - Article 15 provides that insurance companies compute the tax based on the amount of State and local sales tax the claimant would pay if he or she used the entire claim to purchase taxable goods and services. However, under certain circumstances, the Tax Law exempts claimants from paying sales tax. In those situations, insurers would not withhold and remit the Article 15 Tax. The adjustment for tax exempt repair services equaled $132.6 million.

Adjustment for Sales Tax Component of Claims - The total claims paid by insurance companies included money to pay the sales tax on the repair of replacement of damaged vehicles. The Article 15 tax base would not include this money. Therefore, we subtracted this amount from total claims paid. The amount of sales tax paid on 1994 claims was estimated at $178.4 million.

Adjustment for Reimbursement to Claimants - The last adjustment in calculating the Article 15 withholding related to claims insurers pay to reimburse claimants for certain expenses. For example, many policies cover the cost of towing. Often, the insured pays the towing charge then seeks reimbursement from the insurance company. The Insurance Department claims data includes the amount of such claims that insurers pay. However, Article 15 withholding will not apply to these types of reimbursement situations. The adjustment for these types of claims equaled $56.9 million.

Estimate of Revenue Gain

The withheld tax does not represent the revenue gain the State and localities will realize if Article 15 is implemented. To make that estimate, we needed to account for several offsetting factors. The largest offsetting factor was current sales tax compliance. That is, we needed to reduce the estimated revenue gain by the amount of sales tax the State currently collects from repair vendors. Other major adjustments related primarily to the refund provisions provided for under Article 15.

Current Sales Tax Compliance on Repair Services - We estimated that, in the 1994 sales tax year, the sales tax collected on insurance-related auto repair services equaled $103.9 million.[21] The estimate of the gain from enacting Article 15 was reduced by that amount.

Adjustment for Claims Where the Claimant Purchases or Leases a New or Used Replacement Vehicle - Following a motor vehicle accident, a claimant might choose to replace his or her damaged vehicle by purchasing or leasing a new or used vehicle. We believe that Article 15 will not produce any revenue gain in those situations. Therefore, the estimate of the potential revenue gain from Article 15 was reduced by $34.8 million.

Adjustment for Out of State Repairs - In certain instances, New York residents or businesses receiving damage awards may choose to repair the vehicle outside New York. This would probably be most common when the accident occurs outside the state and renders the vehicle inoperable. However, New York residents in areas that border neighboring states may also find it equally convenient to repair their vehicle outside New York.

In instances where a New York claimant opts to repair the vehicle out of state, Article 15 provides for a refund of the tax to the extent of the sales tax paid in the other state. We estimated that the refunds generated by these types of situations would offset the potential revenue gain from implementing Article 15 by $8.7 million.

Adjustment for Claims Where the Claimant Does Not Repair or Replace the Vehicle - Claimants receiving insurance damage awards may choose not to repair or replace the damaged vehicle. Article 15 provides that, in such situations, the claimant is entitled to a refund of the withheld tax. To account for this factor, we reduced the estimate of the potential revenue gain from implementing Article 15 by $17.4 million.

After adjusting for these offsetting factors, we estimated that implementing Article 15 could produce a State revenue gain equaling approximately $4.7 million. Local governments could realize a revenue gain of approximately $4.5 million.

The Revenue Gain Does Not Equal Noncompliance

It is important to clarify that the estimated revenue gain is not synonymous with repair shop noncompliance. The Department identified a number of situations where the State would realize a revenue gain from enacting Article 15 that do not stem from noncompliance. For example, an individual may obtain an estimate to repair a vehicle from one business and subsequently find another business that will perform the work for a lower price. However, if the claim is based on the higher estimate, the insurance company would withhold the Article 15 tax based on that amount. In that situation, the State would gain revenue to the extent that the tax component of the Article 15 award exceeded the sales tax the State would have collected without Article 15 in effect.

Instances where a vendor elects not to accept vouchers is another example of a situation that would produce a revenue gain not related to noncompliance. If an individual elects to have a vehicle repaired by such a business, the repair shop should collect and remit sales tax. However, Article 15 still requires the claimant's insurance company to withhold and remit the Article 15 tax.

Article 15 Costs

The combined first year cost of the tax for businesses, consumers and government will exceed $61 million

The tax will impose significant costs on every insurance company issuing motor vehicle insurance in New York State. It will also impose costs on motor vehicle repair facilities, New York State residents, the Department of Taxation and Finance, the Department of Motor Vehicles and county governments. In the first year, Article 15 costs, including implementation costs, for all of the above parties will total $61.5 million. On an annual basis, the recurring costs for all affected parties will total approximately $33 million. The following discussion provides an overview of the costs associated with Article 15 for each major affected group. Appendix G provides a detailed description of the Department's cost estimates.

Insurance Industry

The insurance industry will shoulder the largest financial burden from enactment of Article 15. The total first year costs to the insurance industry are estimated at $42 million. In addition, the annual recurring cost of the tax for the industry will total $14 million. Most of the expenses that the insurance companies will incur will involve record-keeping and reporting, reprogramming of computer systems and processing of the estimated 1.2 million[22] vouchers that Article 15 will generate annually. In addition, the companies will incur the cost of explaining the Article 15 provisions to consumers, handling complaints and resolving claim problems.

Motor Vehicle Repair Industry

Article 15 will impose first year costs of approximately $6.9 million on the motor vehicle repair industry. Annual recurring costs in subsequent years will total approximately $7.4 million.[23] Most of the costs imposed on the repair industry will involve record-keeping and reporting requirements. Repair shops will also incur costs associated with the time they will spend explaining the Article 15 system to customers.

New York Motorists

Each year, New York motorists file more than 1.3 million auto physical damage claims. For most drivers, an accident is an uncommon occurrence that requires dealing with a complicated web of police reports, insurance claims, deductibles and repair estimates. With Article 15 thrown into the equation, the situation will become even more complicated for motorists.

Under Article 15, claimants will need to develop an understanding of the voucher system. In addition, they will confront any number of situations that could further complicate their dealings with the tax. For example, a motorist may prefer to have an auto body shop repair his fender, but want to have his shattered windshield replaced by an auto glass specialist. In that situation, the claimant would need to return the original voucher to the insurer. The insurer would then issue two separate vouchers: one to use at the body shop and one to use at the glass shop. Arranging this will require the State's citizens to spend time learning the Article 15 system. The value of the time claimants were to spend on this learning process is estimated to equal at least $7 million annually.

As mentioned previously, some of the State's revenue gain from implementing Article 15 is attributable to the State keeping money that claimants are currently entitled to keep. For example, some individuals will not use their Article 15 vouchers but may fail to request a refund. Others may have their car repaired for less than the amount of their damage awards. In those situations, the State gains revenue equal to the amounts of the unused portions of the vouchers. However, that revenue gain equates to a loss of money for claimants.[24]

Article 15 could prompt insurance premium increases of $42 million in its first year

Finally, insurance companies are likely to pass through most or all of the cost of complying with the Article 15 tax to consumers. Therefore, the tax will increase the cost of motor vehicle insurance in New York State. If insurance companies pass through all of the cost, the resulting premium increase in the first year will total approximately $42 million.[25]

State and Local Government

Finally, the State and local governments will incur costs associated with the enactment of Article 15. The Department of Taxation and Finance will incur approximately $4.2 million in first-year costs associated with the program. Most of these implementation costs will involve computer system changes as well as developing and mailing information to affected businesses. In addition, the Department will incur annual recurring costs of approximately $3.7 million. These costs will stem primarily from processing tax returns, processing magnetic media reports (filed on a quarterly basis by insurance companies), data entry of voucher information and processing refunds. In addition, the recurring costs include incremental costs associated with auditing insurance companies and motor vehicle repair shops to ensure compliance with Article 15.

The Department of Motor Vehicles and county clerks around the State will also incur costs associated with Article 15. The tax would require both local DMV offices and county clerks to accept vouchers in lieu of collecting sales tax when they register vehicles purchased with proceeds from a damage award. In turn, the DMV offices and the county clerks would remit the sales tax vouchers to the Department. The estimated first-year cost of altering accounting systems to accommodate this requirement is approximately $200,000. Thereafter, the annual recurring cost to DMV will total $120,000.

Table 5 summarizes the total costs of implementing and administering Article 15.

Table 5: Article 15 Costs

Entity	First Year Annual Costs	Recurring Costs
Insurance Companies	$42.0 million	$14.0 million
Vehicle Repair Facilities	$ 6.9 million	$ 7.4 million
Motor Vehicle Dealerships	$ 1.2 million	$ 1.4 million
New York Residents	$ 7.0 million	$ 7.0 million
Department of Taxation and Finance	$ 4.2 million	$ 3.7 million
Department of Motor Vehicles	$ 0.2 million	$ 0.1 million
Total	$61.5 million	$33.6 million

The Costs of Article 15 Outweigh its Potential Benefits

We estimate that Article 15 would allow the State to collect approximately $9 million above the amount it currently collects in State and local sales tax on insurance-covered repairs. Part of the revenue gain results from collecting tax on currently unreported repair services. However, the remainder results from collecting the tax on that part of insurance awards not used to repair or replace damaged vehicles; proceeds that claimants now may keep.

The first year costs of Article 15 exceed its potential benefits by $52 million

In contrast, we estimate the total first year compliance and administrative costs associated with Article 15 will total $61.5 million and the annual recurring cost of the program will total $33.5 million.

Clearly, the total costs of Article 15 outweigh its potential benefits. In fact, as shown in Table 6 below, it appears the first year costs of Article 15 will exceed its potential benefits by more than $52 million.

Table 6: Net First Year Impact of Article 15

Increased State and Local Revenues Resulting from Article 15	$ 9.2 million
Total First Year Costs Imposed by Article 15	$61.5 million
Net Loss from Implementing Article 15	(52.3) million

Qualitative Analysis of Article 15

Article 15's sponsors expected the tax to improve sales tax compliance in the repair industry and to address the issue of insurance fraud. In addition, they expected Article 15 to address a situation often confused with sales tax evasion or insurance fraud, in which individuals profit from an insurance claim by retaining all or part of the claim money.

Article 15 will not effectively address issues related to insurance fraud. Moreover, the issue of claimants profiting from claims stems from misinterpretation of the Tax Law and is not a genuine problem.

Insurance Fraud

Fraud represents a significant problem in the automobile insurance industry. In fact, an insurance industry newsletter reported that fraud exists in about 10 percent of collision claims.[26] When the State enacted Article 15, its supporters believed it would address insurance fraud problems as well as sales tax compliance problems. However, both the Department of Taxation and Finance and the Insurance Department concluded that Article 15 will not deter insurance fraud.

Article 15 will not deter insurance fraud

Fraud on physical damage claims usually results from claimants and unscrupulous repair facilities submitting false or inflated estimates of repair costs. For example, an individual and a repair shop may conspire to submit an estimate of $2,000 for damages that could be repaired for $1,000. Article 15 will be ineffective in combating this type of fraud. Under Article 15, the insurance companies would withhold and remit tax on the inflated amount and claimants would receive a voucher based on that inflated amount. Article 15's only possible benefit to the State in that situation is that the State would receive withheld tax on the inflated amount. In effect, this would allow the State to also benefit from the fraud. Furthermore, a number of methods exist that would allow an individual or a repair shop to realize the full economic benefit of the fraudulently inflated sales tax component reflected on the voucher. We discuss these methods later in more detail.

"Phantom Fraud"

Sales tax on repairs is not due until the repair is performed. Moreover, the amount of the sales tax liability is based on the ***actual*** cost of the repair.

The State is not owed sales tax until the repair service is actually rendered

Proponents of Article 15 appear to believe that an individual who retains the sales tax portion of a damage award has cheated the State out of tax revenues. However, no tax evasion actually occurs in such cases. For example, an individual may receive a damage award of $1,070 — $1,000 for the damage repair and $70 to pay the sales tax on the repair. The State is not entitled to that sales tax money until the repair is made. A claimant who decides not to repair the car is entitled to keep the $1,070; under the terms of the insurance policy, the money clearly belongs to the claimant at this point. Likewise, if the car is repaired for $500, the claimant is only required to pay sales tax on that lower amount and is entitled to keep the balance. Neither of these situations constitutes fraud or sales tax evasion. They are simply the result of individuals being reimbursed for losses and making their own personal decisions on how to best spend the proceeds of that reimbursement.

Sales Tax Compliance

Outright sales tax evasion by vendors and their customers can take various forms.[27] Four specific patterns of evasion include:

- never collecting the tax (a problem that is particularly pervasive among unregistered businesses);
- collecting the tax but simply "pocketing" it and never reporting the sale;
- absconding with sales tax collections when a business ceases doing business in the State; and
- misusing tax exemptions and exemption certificates.

The tax fails to address compliance problems in more than 76 percent of the vehicle repair industry

The Article 15 tax attempts to address these situations as they occur in the repair industry. However, primarily because of the problems discussed below, the Article 15 measures will not effectively address these problems.

The Provisions Affect Only a Small Portion of the Repair Industry. Article 15 primarily affects body repair and painting shops. However, those vendors comprise less than 24 percent of the total population of repair businesses. Therefore, in spite of its high costs, the program will fail to confront sales tax related compliance problems in more than 76 percent of the motor vehicle repair industry.

Claimants Can Easily Circumvent the Program. The refund provisions in Article 15 present a loophole that individuals could use to circumvent the tax. Persons certifying that they will not repair their vehicle for at least one year, become eligible for a full refund of the Article 15 tax withheld. Upon receiving a refund, their circumstances become essentially the same as before the enactment of Article 15. That is, they would have the damage award, including the sales tax component, in hand as they shop for repair services. At that point, the effectiveness of the tax is completely negated. The claimant could take the damaged car to any registered or unregistered repair shop and pay cash for the repair. The business might then fail to report the transaction or remit the tax, just as it might under current law.

Of course, if an individual repairs the car within one year, he or she is violating Article 15. However, the Department is unlikely to find it cost effective to investigate when an individual repaired his vehicle. Investigations would be particularly impractical if many claimants request refunds.

Repair Shops Could Easily Circumvent the Program - The ease with which vendors can skirt the system will compromise the effectiveness of the tax. The Article 15 tax stems from a mistrust of certain members of the repair industry. Yet, it relies heavily on the honesty of these very businesses to properly handle vouchers. In practice, unscrupulous businesses would likely use the system to their benefit, at the expense of State and local tax revenues.

The irony of the tax is that it depends largely on the cooperation of the supposedly noncompliant businesses

One way for unscrupulous vendors to abuse the system would involve applying a voucher to unrelated repair work on the same vehicle, or other vehicles. For example, assume an individual files a claim for a dent in a car door. The insurer would send the claimant a check covering the damage. The insurer would also send the claimant a voucher for the amount of the sales tax that would be due if he or she used the entire claim to repair the door. However, the individual may decide that, from a safety perspective, he or she would benefit more from having new brakes and tires installed on the car. The individual may then search out an unscrupulous vendor that will accept the voucher as partial payment for the brakes and tires. Once in possession of the voucher, the vendor could easily, though illegally, claim a credit on his sales tax return for the amount of the voucher.

This practice could give vendors a new way to keep sales taxes they collect from non-insurance related repairs while continuing to report the amount of those sales. Because the vendor’s level of sales activity would not change, it would be difficult to detect this type of noncompliance. As a result, the Department would need to increase audits to examine the vendor’s books and records and insurance information related to damage awards.

Shifting Underreporting - Unscrupulous repair shops may also respond to Article 15 by shifting the source of underreporting. Once in place, Article 15 may deter a presently noncompliant repair shop from underreporting insurance-related auto physical damage repair services.

That is not to say it would keep that repair shop from failing to report more of its general repairs. Again, such underreporting could only be detected through expensive audits of each vendor.

Other Considerations

Impact on New York Residents - Many citizens will view the Article 15 program as an intrusion into their personal finances and consumer decisions. In a fairly common situation, a motorist may have an accident involving cosmetic, but little functional damage to a vehicle. Currently, they can use the claim proceeds to repair the vehicle or, for a more pressing need. Under Article 15, while still free to make these same choices, the motorist must keep the State informed of his decisions to qualify for a refund of his own money. For example, an individual may take a vehicle out of use after an accident and use the insurance money for another purpose. Six months later the individual may decide that he is ready to repair the vehicle. If he had received a refund of the sales tax portion of the insurance claim, he may not repair the car until one year from the time the insurer paid the claim. Therefore, to comply with the law, the individual must wait an additional six months to repair his car. Alternatively, the individual could repair the car, but would then be violating Article 15 and subject to a substantial penalty. There is no provision in Article 15 that allows an individual that received a refund to change his mind and repair the car sooner than one year from the date the insurance company paid the damage award.

New York residents will likely view the program as an intrusion into their personal finances and consumer decisions

Another example of Article 15's intrusiveness involves situations where an individual repairs his own car after an accident. Again, under Article 15, this would no longer be a private matter. To repair his own car, he must return the voucher to the insurance company along with a list of the suppliers from whom he will purchase the needed parts. The insurer would then cancel the original voucher and issue new multiple vouchers to cover the intended transactions.

Exempt Sales - The Article 15 provisions will further complicate administration of the current sales tax exemptions. The sales tax exemption for farm production equipment provides a good illustration.[28] Farms do not owe sales tax on repairs to trucks and other vehicles used in farm production. Currently, a farm obtains the exemption by presenting an exemption document to a vendor that performs the repair service. The vendor then keeps the exemption document for at least three years as proof of the exempt sale.

Under Article 15, the farm would also need to prove to its insurance company that it is repairing an exempt farm production vehicle. That means that the insurance company could not process a claim until it receives the proper documentation. From the farm's perspective, Article 15 means that it will need to provide documentation twice - once to the insurance company and again to the repair shop. Moreover, the farm's service from its insurer is likely to be slower since its claim cannot be processed until it provides an exemption document.

The tax will result in burdensome new regulations and requirements for New York businesses

New York's Business Climate - New York has begun to make significant improvements in its business climate. For example, the State recently began a significant effort to identify those regulations that are excessively burdensome for companies doing business in New York. Implementation of Article 15, however, will result in new regulations and requirements for New York businesses. Consequently, the tax may foster a perception that New York is inhospitable to business. Moreover, the tax may convince some smaller insurers to stop writing vehicle insurance policies in New York State.

Alternatives to Article 15

We examined four possible alternatives to the Article 15 system. One alternative represents a streamlined version of the current Article 15 Tax. A second involves amending the Insurance Regulations governing how insurers pay motor vehicle claims. The third alternative involves developing sales tax information directed specifically to the repair industry. A fourth alternative entails auditing of the industry combined with developing improved methods for identifying noncompliant businesses.

Streamlining Article 15

One alternative we examined would leave Article 15 in place. However, it would simplify the tax and direct it toward particular compliance problems. In effect, the alternative would reduce Article 15 costs while attempting to maintain a tax collection benefit. The two main components of a streamlined Article 15 system include reducing the number of transactions and eliminating the voucher system.

Reducing the Number of Transactions - The State could simplify Article 15 by scaling back the number of transactions subject to the tax and eliminating the voucher system. To limit the number of Article 15 transactions, the alternative could exempt the following from the tax:

- total loss claims;
- losses due to theft;
- small losses (e.g., damages of less than $1,000); and
- claims of New York residents settled outside New York.

These exemptions would narrow the scope of the tax. Consequently, they would lessen Article 15's impact on the insurance industry and the repair industry. Also, a claims threshold would eliminate small damage claims in which the motorist would be more likely to perform his or her own repair or leave the vehicle unrepaired.

Eliminating the Voucher System - The tax exemptions would reduce program costs. However, to provide significant cost savings, particularly for the insurance industry, the State must also eliminate the Article 15 voucher system.

Under a streamlined alternative, the State could continue requiring insurance companies to withhold a transfer tax on covered insurance damage awards. However, the insurers would not issue credit vouchers. Instead, the sales tax law would exempt the repair or replacement of vehicles subject to the transfer tax. Thus, rather than issuing vouchers, insurers would give claimants an exemption document or other certification of the details of the claim. Insurers would report the information to the Department on a quarterly basis.

Under a revised Article 15 system, when a motorist repairs or replaces a vehicle, he or she would provide the exemption documentation to the repair shop. The repair service would be exempt from sales tax to the extent of the value of the Article 15 tax paid.

Any alternative that shares Article 15's structure will also share many of its problems

In some respects, this alternative represents an improvement over the Article 15 system currently scheduled to take effect. However, it still represents an inefficient approach to improving compliance. The alternative retains the basic elements of the Article 15 tax. Therefore, we have the same conceptual objections to the streamlined approach. Furthermore, this type of alternative would continue to impose costs on businesses and burdens on individuals.

We also have a major concern with the sales tax exemption granted by this alternative. Exemptions rely heavily on the voluntary compliance of those issuing the documents and those receiving them. The streamlined system would rely on the voluntary compliance of insurance claimants and repair shops - the very parties whose alleged lack of compliance led to the Article 15 tax. Therefore, the system could actually create more compliance problems in the industry.

In short, many issues raised with respect to the Article 15 tax stem from its basic structure. As a result, any alternative that shares the same structural elements will also share many of its problems.

Two-Party Checks

Typically, when insurance companies pay damage awards in New York they cut a check to one party— the claimant.[29] However, in many other states, insurance companies write the check to two parties— the claimant and the business designated to repair or replace the vehicle. When a claimant receives a two-party check he usually endorses it and turns it over to the repair shop or auto dealer as payment for the repair or replacement. Current New York State Insurance Regulations prohibit companies from issuing two-party checks to claimants and repair shops. The basis for this prohibition is the State's position that claimants are entitled to the full amount of compensation for their losses.

Expanded use of two-party damage award checks could produce some tax compliance benefits

New York State could allow insurance companies to issue two-party checks to New York claimants while still ensuring that insurers fully compensate claimants for their losses. The State could accomplish this by changing the Insurance Regulations to allow, but not require, two-party checks to claimants and repair shops. Under such a system, claimants choosing to repair or replace their vehicles could accept the two-party check, endorse it and turn it over to a repair shop or auto dealer as payment for their repair or replacement. However, an individual who prefers a single party check could return the two-party check for a check made out only to himself. Simpler yet, at the time that a claimant files a claim, insurance companies could ask the claimant to indicate whether he or she would prefer a single party or two-party check.

Using two-party checks could produce some tax compliance benefits. Moreover, the insurance companies could find that it benefits them by ensuring that claimants make their repairs properly. However, the allowance of two-party checks could also present difficulties for New York claimants.

Advantages - From a tax compliance perspective, a two-party check system could provide a source of third-party data we could use for audit selection. Third-party data may prove a valuable tool for identifying noncompliant repair businesses. In this instance, we could request, from insurers, computer tapes listing businesses named on two-party checks. That information would identify businesses that are not registered sales tax vendors. It would also identify businesses whose reported taxable sales appear significantly lower than the total amount of the checks made payable to them.

Motor vehicle repair businesses may also favor the use of two-party checks in New York State. The industry may find that it could help reduce the number of situations in which they receive “bad checks” from customers, i.e., checks backed by insufficient funds. In addition, two-party checks could decrease instances of individuals taking their vehicle to unregistered businesses for “cut rate” repairs.

Many insurance companies may also favor the two-party check system. The industry may find that two-party checks encourage more individuals to repair their vehicles correctly rather than trying to repair their vehicles while generating a little cash benefit on the side.

Disadvantages - The two-party check system could prove inconvenient for some claimants. For example, a claimant may indicate to an insurance company that he intends to take his or her vehicle to ABC Garage for the repair. Therefore, the insurance company will cut the check to the claimant and ABC Garage. Subsequently, the claimant may decide that he would rather have XYZ Garage repair the vehicle. The claimant would then need to return the check to the insurance company and wait for a replacement check. That could delay the repair.

In another situation, the claimant may indicate a preference for a two-party check but subsequently decide that a single party check would more appropriately meet his needs. For example, the individual may have intended to repair the automobile but then decided to replace it. In such situations, the system could prove inconvenient for the claimant as he would need to return the original check and wait for a replacement check.

Taxpayer Assistance

Providing publications and other material relevant to business operations represents an important part of the Department's education and outreach efforts. As part of a compliance initiative in the motor vehicle repair shop industry, the Department could make available comprehensive sales tax information specifically directed to repair shops. By providing that information, we may forestall future tax compliance problems in the motor vehicle repair industry.

Focused Audit Program

We also analyzed whether we could improve sales tax compliance in the repair industry through a program combining:

- screening new motor vehicle repair businesses to ensure that they register as sales tax vendors;
- improving methods to identify noncompliant repair businesses; and
- increasing audits of the repair industry.

Diverting sales tax auditors from their current activities to auditing motor vehicle repair shops would not be a wise use of taxpayer money. However, some of the above elements could be incorporated into the general sales tax audit program.

Diverting sales tax auditors to auditing of motor vehicle repair shops would not be economically efficient

Require Sales Tax Registration for Motor Vehicle Repair Shop License - As discussed earlier, motor vehicle repair shops must register with the Department of Motor Vehicles. The term "motor vehicle repair shop" describes businesses that repair or diagnose motor vehicle malfunctions or repair motor vehicle bodies, fenders or other components. Facilities such as oil change shops and tire stores are not considered motor vehicle repair shops.

Under current procedures, DMV asks license applicants to provide their sales tax registration number. However, DMV does not specifically verify the accuracy of that information. We believe that compliance would improve if, before issuing a repair shop license or license renewal, the Department of Motor Vehicles verified that the applicant properly registered for sales tax.

There are several possible ways that DMV could verify the accuracy of the information applicants provide. One possibility would provide DMV with limited access to sales tax files. Another option would involve DMV providing a list of license applicants to the Department of Taxation and Finance, probably on a daily basis. Personnel would then check the sales tax file and provide the Department of Motor Vehicles with a clearance to approve the application. A third approach would require that license applicants attach a copy of their sales tax Certificate of Authority to the application for a facility license or license renewal.

A more limited approach would involve DMV notifying the Department, perhaps monthly, of new licensees. We would then have responsibility to verify the sales tax registration of those businesses. This option maintains a benefit of early identification of unregistered repair shops. However, it does not increase regulatory requirements on repair shop license applicants and would not impede new business development in New York. Furthermore, the State could decrease the cost of any of the tax clearance options, without losing much of their effectiveness, by limiting the screening to businesses that are registering with DMV for the first time.

Require the Department of Motor Vehicles to Provide Information Regarding Unregistered Vendors - The Department of Motor Vehicles runs an ongoing program to identify businesses that repair motor vehicles without first registering as a repair shop. In the twelve month period ending August 31, 1994, the most recent year for which data is available, this program discovered 1,093 unregistered repair shops. If DMV shared this information regularly with the Department of Taxation and Finance, we could audit these businesses. Failure to register as a repair shop likely correlates highly with failure to register as a sales tax vendor. Therefore, this initiative could help to identify unregistered sales tax vendors in the industry. Since the program piggybacks on an existing DMV effort, it should prove cost effective.

Increase Use of Third-Party Reporting for Audit Selection - We conducted a test project to identify, for audits, repair shops that may be underreporting taxable sales (Appendix E discusses the initiative in more detail). The project involves comparing records of vehicle parts purchases (obtained from suppliers' sales records) to repair shops' reported gross sales. Repair shops with an unacceptable ratio of purchases to sales (i.e., those businesses that appear to have purchased a large quantity of parts but that have not reported comparable sales) would be selected for sales tax audits. The initial results of the pilot project indicate that it could serve as a useful tool for audit selection.

Increase Auditing of the Repair Industry - The first three steps described above help identify repair facilities that may be noncompliant. The critical final element is increased auditing of the industry. However, increased auditing of the motor vehicle repair industry, at the expense of auditing vendors in other industries, is not cost effective.

Our current audit selection methodology, applied to audits of vendors from all industries produces audit collections of $4,100 per audit day. If we hired field auditors solely to conduct additional audits of repair shops, their yield per audit day would equal less than one-tenth that amount. Therein lies the problem with increasing audits of the industry. Focusing additional audit resources on audits of the motor vehicle repair industry would be a poor use of the State's limited resources.

Some compliance improvement initiatives, if incorporated into the Department's normal audit program, may prove effective

While increasing these types of audits does not appear efficient, some initiatives, if incorporated into the Tax Department's normal audit program, may be effective. For example, the sharing of DMV information should increase the overall effectiveness of our current unregistered vendor program.

Recommendation

Given the absence of any substantial quantitative evidence of the need for the program, and considering its potentially broad negative impacts on businesses and consumers, we recommend that the State repeal Article 15.

In place of the tax, the State could consider enforcement measures that are less intrusive and less costly to businesses and the State. Those measures should include targeted responses to specific compliance problems without imposing burdens on large numbers of businesses and residents.

Endnotes

1. Throughout this report all references to "sales tax" refers to both the sales tax and the compensating use tax.

2. "News from Assemblyman Ivan Lafayette," Press release dated May 30, 1991.

3. Required by Insurance Department Regulation: NYCRR Title 11 Section 216.6(b).

4. In a casual sale transaction, the claimant would pay the sales tax to the Department of Motor Vehicles at the time that he or she registers the replacement vehicle.

5. The Article 15 tax equals the amount of sales and compensating use tax that would be due if the entire damage award were spent to repair or replace the damaged vehicle, or to purchase other taxable goods or services.

6. Other businesses involved in accepting vouchers would include motor vehicle parts retailers.

7. Article 15 does not require vendors to accept all vouchers. This arrangement protects repair shops, motor vehicle dealers and other vendors from having to accept suspicious or counterfeit vouchers.

8. *National Association of Independent Insurers et al., v. State of New York, Order of the Supreme Court entered April 23, 1992 in Kings County.*

9. *National Association of Independent Insurers et al., v. State of New York, 207 AD2D 191, 620 NYS2d 448.*

10. Chapter 2 of the Laws of 1995 also delayed implementation of Article 15 until September 1, 1996.

11. The 1994 sales tax year is from June 1, 1993 through May 31, 1994.

12. The Table 1 profile does not include vendors performing repair services but generating most of their sales from other sources. For example, the profile does not include dealers, retail filling stations, parts suppliers or general merchandise retailers.

13. The sales tax liability figures are as reported on tax returns. This report discusses reported tax liability in terms of "tax collected" or "tax remitted." However, actual collections may differ from reported liability.

14. *Improving Sales Tax Compliance: Preliminary Report*, Department of Taxation and Finance, February, 1992 and *Improving Sales Tax Compliance: Recommendations for a Compliance Improvement Program*, Department of Taxation and Finance, January, 1993.

15. The number of DMV licensed repair shops differs from the number of registered sales tax vendors in the industry. The Department of Motor Vehicles provides facility licenses to each establishment that repairs motor vehicles. In comparison, a sales tax vendor registration can relate to a single company operating a chain of repair facilities. Moreover, the tax analysis excludes certain repair facilities, e.g., a general merchandise retailer which also operates an automobile repair facility.

16. The 12 month period examined was from September 1, 1993, through August 31, 1994.

17. To date, the Department has requested information regarding sales to New York businesses from more than 1,100 automobile parts suppliers. The Department may use the records it obtains from the wholesalers in two ways. First, the Department can compare the purchases of the retail businesses to their reported amounts of total sales and taxable sales. That comparison will indicate whether underreporting seems likely. Secondly, the Department can use the wholesalers' information to identify businesses that appear to be selling parts and/or performing repairs but that are not registered sales tax vendors.

18. An audit assessment results when an auditor finds that a vendor owed more tax than the amount reported. However, assessments do not always indicate tax fraud or intentional cheating. Noncompliance occurs in a variety of forms and for a variety of reasons. Recently, the State of Washington found that "lack of awareness" among taxpayers accounted for nearly half of the state's compliance problems (State of Washington Department of Revenue, *Washington State Excise Tax Noncompliance Study*, August, 1990).

19. The comparative group consists of all vendors audited in the 1993-1995 state fiscal years whose annual reported taxable sales were within the range of $0 to $3,173,820, i.e., the range of reported taxable sales for the repair industry. Appendix E discusses the selection of the comparative group in more detail.

20. Insurance companies paid $1,476 million of total claims under comprehensive or collision policy coverage and $844 million in claims under property damage liability coverage.

21. The Department based this estimate on sales tax return information from vendors in the vehicle repair industry combined with information provided by the advisory panel.

22. We based the estimated number of vouchers on the number of 1994 claims as reported by New York insurers. The 1994 claims data is unverified by the New York State Insurance Department. In 1994, New York claimants filed 1.3 million claims. After adjusting for claims that will not be subject to Article 15, we estimated the tax will generate 1.2 million vouchers annually.

23. Because of the increased cost of undergoing audits, the program cost is higher in the second and subsequent years than in the first year.

24. The Department was not able to estimate the cost of this lost money for claimants.

25. Because the Department attributed these costs to the insurance industry, they are not included in the Department's estimated total Article 15 costs to residents.

26. Rennie, Eric, "Ten Causes of High Auto Premiums - and Their Cures," *The Hartford Agent*, Volume 81, Number 6, 1989.

27. *Improving Sales Tax Compliance: Preliminary Report*, Department of Taxation and Finance, February, 1992 and *Improving Sales Tax Compliance: Recommendations for a Compliance Improvement Program*, Department of Taxation and Finance, January, 1993.

28. There are a number of other examples of exempt purchases that will be affected by Article 15. Tractor-trailer operators are not subject to sales tax on repair services to their tractors or trailers. Businesses that rent or lease vehicles to others are also not subject to sales tax on repair services to the vehicles sold or leased. Finally, there are more than 70,000 tax exempt organizations in New York State that do not owe sales tax on repair services. These organizations include religious organizations, hospitals, volunteer fire and ambulance companies and private schools, colleges and universities.

29. There are certain exceptions to this rule. For example, on leased vehicles the check is typically written to the lessor and the lessee. Also, insurers may write two-party checks to a claimant and the vehicle's lien holder.

Appendix A: Summary of Article 15

Insurance Company Requirements

Article 15 of the Tax Law requires authorized motor vehicle insurers to withhold a tax on certain motor vehicle insurance awards.[1] Insurance awards subject to this tax include motor vehicle claims made for damages, total loss, or theft. The tax also applies to awards covering towing, storage, replacement rental or mechanical breakdown.

This tax places many new responsibilities on insurers. It requires these companies to:

- register as a New York State sales tax vendor (if not already registered);
- withhold a “tax component” on every award;
- issue a voucher and stub to the claimant in the amount of the tax component withheld;
- file a tax return to report and pay over the withheld tax;
- file reports (via magnetic media) about vouchers and stubs issued;
- retain detailed records of transactions concerning withheld tax and vouchers and stubs;
- issue multiple vouchers and stubs where a motorist contracts with more than one vendor to repair the motor vehicle or, upon request, cancel an original voucher and issue new multiple vouchers to cover the intended transactions;
- replace lost, stolen or destroyed vouchers and stubs; and
- refund the tax withheld, under limited circumstances.

Registration

Article 15 requires every insurance company authorized to issue motor vehicle insurance in New York to register as a New York State sales tax vendor. Insurance companies must obtain a separate sales tax registration for each discrete code assigned to it by the Department of Motor Vehicles.[2]

Withholding the Tax Component on Damage Awards

Insurance damage awards consist of two components -- the claim amount and the tax component. The motor vehicle insurer must withhold the tax component of the award. The tax component of the award equals the combined State and local sales and use tax a consumer would pay if the entire award (computed without regard to the tax component of the award) was used to repair or replace the motor vehicle. Insurers must compute the tax component before considering any policy deductibles. In other words, the Article 15 tax insurers must withhold is based on the actual payment amount plus the deductible amount.

More than 80 counties and cities currently impose sales and use tax in New York. When computing how much tax to withhold, insurers must be certain that they have used the correct combined State and local sales tax rate. To comply with this aspect of Article 15, insurers must consider many factors.

Where the motor vehicle is a total loss and the claimant is an individual, the applicable combined rate of sales and use tax is the rate in the jurisdiction where the claimant resided immediately before the loss. Where the vehicle is a total loss and the claimant is a business, the applicable rate is the rate where the vehicle was principally used or garaged immediately before the loss.

Different rules apply in determining the applicable rate when the motor vehicle is not a total loss. In such situations, where the claimant is an individual, the Article 15 tax is computed using the higher of the combined sales and use tax rate in the local jurisdiction where the claimant will have the vehicle repaired or the rate in the local jurisdiction where the claimant resided immediately before the loss. Where the vehicle is not a total loss and the claimant is a business, the applicable rate is the combined sales and use tax rate where the vehicle was principally used or garaged immediately before the loss.

With respect to any portion of the damage award not used to repair a vehicle, the tax is computed at the combined rate in the jurisdiction where the claimant lived immediately before the loss (for an individual). Where the claimant is a business, the tax is computed at the combined rate in the jurisdiction where the vehicle was principally used or garaged immediately before the loss.

Issuing Credit Vouchers

When an insurer settles a motor vehicle claim, it must issue a credit voucher and stub in the amount of the tax component withheld. The insurer may issue more than one voucher and stub for the same award (e.g., to pay for storage charges, a vehicle rental, the repair, etc.). However, the total value of all vouchers may not exceed the tax component of the award.

Insurance companies produce the credit vouchers. These vouchers must meet a variety of special requirements. They must be serially numbered, counterfeit-proof and non-transferable. The counterfeit-proof aspect of vouchers requires special printing techniques. It also requires printers hired by insurance companies to produce the vouchers to provide a legal certification about the number of vouchers printed. Moreover, insurance companies must submit vouchers to the Department for approval before using them.

Each voucher also must contain detailed information about the motorist and the vehicle. This information includes the date of issuance of the voucher as well as the motorist’s name, address, county of residence and federal identification number or social security number. Vouchers must also state the vehicle identification number, year, make, and license plate number of the damaged motor vehicle. Finally, the credit voucher and stub must contain a statement that they expire one year from the date of issuance and contain the signature of the insurer’s designated officer or employee.

Usually, the insurer will provide the voucher directly to the motorist. However, where the insurance company and the claimant agree that the insurer will purchase tangible personal property or services directly from a vendor, the insurer can provide the voucher and stub directly to that vendor.

Filing Returns and Remitting Tax

Article 15 requires authorized insurers, as registered sales tax vendors, to file sales tax returns. Insurers must file the returns monthly if their damage awards paid and taxable sales and purchases subject to use tax total $300,000 or more in any one quarter of the preceding four sales tax quarters. Those insurers whose total damage awards and taxable sales and purchases are less than $300,000 must file returns and pay tax quarterly. An insurer whose damage award and sales and use tax liability is less than $250 in a year may elect to file annually.

Monthly sales tax returns are due the 20th day of the following month. They cover the tax due for the prior month. Quarterly returns are due the 20th day after the close of the sales tax quarter. Sales tax quarters end February 28 (February 29 in leap years), May 31, August 31, and November 30. The annual filing period ends May 31.

Insurers paying over the Article 15 tax must also complete a separate Article 15 tax schedule. This schedule summarizes the value of the damage awards issued and tax withheld in the applicable monthly or quarterly period. For insurers filing tax monthly, the schedule is only due quarterly.

Article 15 also requires that insurers file quarterly reports containing all of the information shown on each voucher issued. Insurers must submit these reports on magnetic media or in other machine readable form. These reports also must include information about voucher replacements and cancellations, refunds and exempt payments to nonresidents. If filing reports via magnetic media puts an “undue hardship” on a taxpayer, the Tax Commissioner may grant an exception to that requirement.

Keeping Records

Registration as a sales tax vendor, subjects insurance companies to all of the general sales tax record-keeping requirements.[3] In addition, they must maintain records documenting the information contained on the vouchers and in the quarterly reports. In fact, they must maintain a true and complete copy of each credit voucher and stub. Furthermore, insurers must keep records indicating whether payments to or for the claimant was for a total loss. Insurers must retain these records for at least four years from the latest date of payment of any portion of the damage award.

Special Situations

Damage Awards Paid to Nonresidents - In certain instances, insurers do not have to withhold the tax component of an award paid to a nonresident. An exemption covers damage awards meeting the following three criteria:

- the nonresident is not the insured under the policy under which the insurer is paying the claim;
- the motor vehicle is registered in another state; and
- the nonresident provides substantiation to the insurer that the repair or replacement will not take place in New York State.

Damage Awards Paid After the Claimant Repaired or Replaced the Damaged Vehicle - Sometimes a motorist will repair or replace a damaged vehicle before settling with the insurance company. In those cases, the insurer can pay the tax component of the award to the claimant. To do this, the insurer must receive proof that sales tax was paid. Moreover, the tax component paid cannot exceed the amount of sales and use taxes actually paid.

Lost, Stolen, Mutilated or Destroyed Credit Vouchers or Stubs - Where a voucher or stub or both are lost, stolen, mutilated or destroyed, the insurer may issue the claimant, or the vendor who properly had possession of the voucher and/or stub, a replacement. The insurer must obtain from the claimant or the vendor a sworn affidavit attesting to the circumstances requiring the replacement of the voucher and/or stub. The person requesting the replacement voucher and stub must return to the insurer any remaining portion of the original voucher and/or stub in his or her possession. Any replacement voucher and/or stub must be marked “replacement” on its face.

The replacement voucher and stub must contain the identical information that the original credit voucher and stub contained and must have the same issuance date that appeared on the original credit voucher and stub. Thus, a replacement will expire on the same date as the original.

Upon issuance of the replacement voucher, the original voucher and stub become null and void. The insurer must invalidate the original credit voucher and stub and notify the Tax Department (on the appropriate form) of the cancellation and replacement.

In each of these special situations, the insurance company must maintain records documenting the transaction. Specifically, this includes records for damage awards paid to nonresidents of New York State. It also includes records of refunds made to the claimant in cases where the claimant had paid sales tax before receiving the voucher.

Penalties

In addition to other penalties provided by law, Article 15 provides for penalties when an insurer fails to provide the information required on its tax return or fails to furnish a properly completed credit voucher and stub to the claimant. The penalty is $50 for each such failure. The minimum penalty is $1,000. However, the penalty cannot exceed $10,000 for the period covered by the return.

Where failure to comply with the provisions of Section 341 of Article 15 is due to reasonable cause, and not due to willful neglect, the Tax Commissioner may, in his discretion, waive the penalty. The Commissioner may also waive interest charges greater than the statutory minimum.

The Tax Law provides for criminal penalties where an insurer: willfully fails to withhold tax; willfully fails to file a return or report; or willfully files or furnishes false or fraudulent lists, returns, reports, accounts, statements or other documents.

Article 15 provides that certain violations of its provisions are Class E felonies. One Class E violation occurs when an insurer fails to withhold tax with the intent to defraud the State, and thereby deprives the State of $10,000 or more. Another occurs when an insurer fails to withhold tax with the intent to defraud the State through a common scheme or plan consisting of ten or more failures to withhold the required tax in the amount of $100 or more each.

Repair Shop Requirements

A repair shop, automobile dealer, or any other retailer may accept a credit voucher and stub instead of collecting sales tax on a covered purchase. The vendor may then claim the redeemed amount as a credit on its sales tax return. However, Article 15 does not require that a vendor accept a credit voucher.

Accepting Vouchers

When accepting a voucher, a repair shop or other vendor must take the following steps:

- Check that the voucher is an original, valid voucher. For example, the voucher part should contain a line under the title. To the naked eye, the line appears as a fuzzy or broken line. However, upon magnification (8x) the line reveals the series of letters "NYSTAX." Thus, a vendor could examine each voucher under magnification as one way to ensure that it is not counterfeit.[4]

- Ensure that the customer presents both the credit voucher and stub. The customer does not retain any portion of the voucher/stub.

- Check that the insurer issued the voucher to the individual redeeming it. The shop must also check that the voucher is for the motor vehicle being repaired or replaced.

- Verify that the voucher has not expired.

Voucher Validation

After performing these checks, the vendor should complete the voucher validation area. This is done by entering the sales tax identification number, the date, the total sale amount, the sale covered by the voucher, the amount of the damage award,[5] the actual sales tax due and the unused portion of the voucher amount. The vendor also must indicate in the validation area if the customer redeemed the voucher for sales tax on a repair of the indicated vehicle or for its replacement. Finally, the vendor's receipt or invoice must show that the customer presented a credit voucher. It also must show the credit amount applied toward the actual sales tax due.

Lost Vouchers

If a vendor loses a voucher, it must contact the issuing insurance company to obtain a replacement.

Filing Sales Tax Returns

When filing its sales tax return, the vendor calculates the total Article 15 credits used and applies this amount as a credit toward sales tax due. The vendor must also complete a new tax return schedule. That schedule will summarize voucher transactions. The voucher portion of each credit voucher must accompany the repair/replacement vendor's sales tax return and Article 15 schedule. The vendor will retain the stub portion for its records.

Endnotes

1. Authorized motor vehicle insurers are insurance companies licensed in New York to issue motor vehicle physical damage or motor vehicle property damage liability insurance.

2. The New York State Department of Motor Vehicles assigns an "insurance company code" to each separate entity licensed in New York State to issue motor vehicle physical damage or motor vehicle property damage liability insurance. A separate registration is not required for Department of Motor Vehicles Code 999. That code refers to the assigned risk pool.

3. For an overview of the general sales tax record-keeping requirements, see New York State Department of Taxation and Finance, Publication 750 *A Guide to Sales Tax in New York State*.

4. Importantly, under Article 15, it is the responsibility of the repair/replacement vendor to ensure the validity of each voucher accepted. Repair shops, automobile dealers and other vendors that accept vouchers will be liable for the tax shown on the voucher should it prove counterfeit.

5. If known, the repair/replacement vendor must enter the damage award amount, including the deductible. If the damage award amount is not known, the repair/replacement vendor must calculate it by dividing the voucher amount by the applicable tax rate used to compute the voucher amount.

Appendix B: Article 15 Litigation

The State Legislature enacted Article 15, section 341, of the Tax Law on June 3, 1991. It was scheduled to take effect September 1, 1991. Before its implementation, the National Association of Independent Insurers (NAII) and several insurers moved for a temporary restraining order and preliminary injunction to prevent Article 15, the implementing regulations and the voucher specifications from taking effect. On August 29, 1991, just three days before the scheduled effective date, the Supreme Court, Kings County, granted the temporary restraining order.

Subsequently, the NAII's legal representatives and the New York State Attorney General's Office argued their cases for and against the preliminary injunction. On January 31, 1992, the Supreme Court in Kings County rendered its decision. The Court found that the transfer tax on motor vehicle damage insurance awards was, in essence, a type of sales tax. With the Article 28 sales tax, the Court found that Article 15 permitted double taxation on the same event without the possibility of a refund. The Court also found that the plaintiff NAII and insurers were likely to prevail in an action to declare Article 15 unconstitutional since the Court found that the Legislature did not clearly express the intent to impose double taxation. Furthermore, the Court ruled that the specifications for the vouchers and stubs issued under Article 15 were invalid because they were not promulgated as regulations under the State Administrative Procedure Act.[1]

Upon appeal by the State, the Appellate Division reversed the order of the Supreme Court on December 27, 1994.[2] It remitted the matter back to the Supreme Court, Kings County, for entry of a judgment declaring Article 15, section 341, of the Tax Law constitutional. In support of its ruling, the Appellate Division found the claims of double taxation to be speculative. In the Court's view, those claims did not overcome the strong presumption of constitutionality attaching to tax statutes.

The Appellate Division agreed with the finding of the Supreme Court that the Article 15 tax represented a prepayment of sales tax. However, the Appellate Division found no double taxation, either on the face of the statute or in its operation. In support of this finding, the Court cited existing sales tax provisions which protect taxpayers from unconstitutional double taxation. Also, the Court found that the voucher and stub specifications issued by the Department were valid, because they did not have to be promulgated as a regulation.

On February 10, 1995, the Attorney General, upon advice of the Governor's Office, agreed to continue the stay of Article 15 while the plaintiffs NAII and insurers sought leave to appeal to the Court of Appeals.

The Court of Appeals has scheduled the appeal for oral argument on April 30, 1996. The plaintiff/appellants' brief is due on March 1, 1996 and the State's brief is due on April 1, 1996.

Endnotes

1. *National Association of Independent Insurers et al., v. State of New York*, Order of the Supreme Court granting Preliminary Injunction entered April 23, 1992, in Kings County.

2. *National Association of Independent Insurers et al., v. State of New York*, 207 AD2D 191, 620 NYS2d 448.

Appendix C: Legislative Mandate

Legislation enacted with the Fiscal year 1995-96 State budget included the following mandate for the study of Article 15:

Study of the impact of the implementation of the tax on transfer of certain insurance awards. On or before January 1, 1996, the commissioner of taxation and finance, the commissioner of motor vehicles and the superintendent of insurance, in consultation with industry and consumer representatives, shall submit a joint study to the governor, the temporary president of the senate, the speaker of the assembly, the minority leaders of the senate and of the assembly, the chairman and ranking minority member of the senate finance committee, and the chairman and ranking minority member of the assembly ways and means committee. The joint study shall include a written report coordinated and prepared by the commissioner of taxation and finance. The report will evaluate the rationale for and implementation of the tax on transfer of certain insurance awards including: the cost to the state and private sector of implementing such tax, an estimate of the amount of sales and compensating use tax evasion and fraud in auto repairs in the auto repair and related industries, the anticipated effectiveness of article 15 of the tax law in preventing such evasion and fraud, alternatives to the Article 15 tax designed to minimize such evasion and fraud in such industries, the impact on the affected industries and consumers, and the potential net revenue gain to the state. The report shall reflect the concerns of the affected industries and consumer representatives. The report shall include a joint recommendation as to whether implementation of the tax is in the best interest of the state, the affected industries and consumers. A preliminary report shall be submitted to the aforestated persons on or before November 15, 1995. The data and supporting documentation underlying the report, to the extent allowed by law, shall be available to the persons designated to receive a copy of the final report. The commissioner of taxation and finance shall submit on or before August 15, 1995 to the persons designated to receive a copy of the report, a work plan that describes the study.

Appendix D: Members of the Advisory Panel

<u>Insurance Industry</u>

American Insurance Association
Mary Griffin

National Association of Independent Insurers
Robert Zeman

Alliance of American Insurers
John Cucci

Independent Insurance Agents Association of New York
Michael Barrett

New York State Insurance Association
Bernie Bourdeau

<u>Repair Shop Industry</u>

New York State Auto Collision Technicians Association
Edward Kizenberger

Capital District Auto Collision Technicians Association
Ralph Defibaugh

Long Island Auto Body Repair Association
Vincent Raimo

Auto Body Craftsmens Guild
Albert Porcelli

Automobile Dealers

New York State Auto Dealers Association
Norma Sharp

Consumer Representatives

American Automobile Association
James J. McGowan

Consumer Protection Board
Jean Noel

Department of Motor Vehicles
Ernest Kitchen

Insurance Department
Stuart Keir

Appendix E: Evaluation of Sales Tax Compliance in the Repair Industry

We examined several methods to evaluate sales tax compliance in the motor vehicle repair industry. One method used the results of special Department audit programs. The second method involved analyzing the results of past repair shop audits. Yet another method involved comparing external indicators of industry activity to reported sales tax information. Each method possessed its own strengths and weaknesses.

Analysis of Special Audit Programs

The Revenue Opportunity Division, (ROD) is a unit within the Tax Department that is responsible for identifying where the State is losing tax revenue. ROD then devises and tests cost-effective methodologies for stopping those losses.

In 1993, ROD conducted a program to identify noncompliant businesses in the repair industry. The program involved comparing two data bases to identify businesses performing repairs but not registered sales tax vendors. ROD compared approximately 25,000 motor vehicle repair shops licensed by DMV with the population of sales tax vendors. Ultimately, the program identified only 58 repair shops out of the population of 25,000 that were not registered as sales tax vendors.

Another ROD program uses sales records of vehicle parts wholesalers. Wholesale sales records identify New York businesses purchasing vehicle parts and supplies at the wholesale level. With that information, auditors can find unregistered sales tax vendors. In addition, auditors can compare a registered vendor's parts purchases to reported total sales and taxable sales. This comparison provides a means to select for audit vendors that may be underreporting sales. To date, we have not conducted enough audits through this program to use it as a basis for determining the extent of noncompliance.

Comparison of Sales Tax Collections Data to External Indicators

Comparing sales tax collections to external indicators of sales activity is another method of quantifying noncompliance in the repair industry. We attempted to compare reported taxable sales from the industry to receipts data from the federal Census of Service Industries. However, the Census data was not useable for this purpose.

The Census Bureau data had significantly different data about the number of vehicle repair establishments in New York. The 1992 Census of Service Industries indicates that 8,470 New York establishments are in the automotive repair business. In contrast, the sales tax vendor file indicates that over 17,000 firms provide motor vehicle repair services. This large discrepancy may result from some businesses' failure to respond to the Census questionnaire. It may also be caused by differences in reporting the primary line of business of establishments. Finally, a large part of the difference may be because the Census survey does not include sole proprietorships. Regardless of the cause, the discrepancy makes it impossible to compare Census data to sales tax return data.

Evaluation of Audit Data

Our analysis of audit data came from our audit history file. The audit history data base consists of information from detailed reports that auditors complete at the end of each field audit. In addition to other items, these reports show the amount of tax deficiency the auditor found.[1]

The audit history data base provides a wealth of information. However, the data base is of limited usefulness for general research. First, it reflects only field audit results. Therefore, it does not include any information about central office audits-- audits conducted without visiting a vendor's place of business. Second, we select vendors for field audits through a careful audit selection program, in part because audit managers perceived that compliance problems may exist. Therefore, for statistical purposes, the data is biased. Third, information found in the data base reflects only the assessed amount of additional tax due. It does not reflect the actual amount paid following the audit. Finally, the data does not reflect any reduction in the assessment resulting from taxpayers' success in the appeals process.

Because of these limitations, we could not extrapolate audit results to the industry at large. However, the analysis provides some insight into the compliance of the limited population of vendors audited. Table 3 in the report compares audit assessments for repair vendors to audit assessments for comparably sized businesses in other industries. We based the comparison on statistics from State Fiscal Year 1992-93 through State Fiscal Year 1994-95. We examined the results of all audits conducted on repair vendors during that period. Next, we selected from all other vendors audited during that same period, those vendors whose annual taxable sales were within the same range as the annual taxable sales of the repair vendors ($0 to $3,173,820). This analysis showed us that the repair vendors audited were no more noncompliant than other businesses with similar amounts of taxable sales.

Endnotes

1. A tax deficiency equals the difference between the amount of tax the auditor determined the vendor should have paid and the amount actually paid. The report presents findings related only to the sales tax. Although use tax comprises an important part of audits, it falls outside the scope of this analysis.

Appendix F: Estimate of Potential Revenue Gain from Article 15

The potential State and local revenue gain from enacting Article 15, before considering offsetting costs, equals approximately $9 million.

Estimate of Article 15 Withholding

Damage Award Claims - The estimate begins with the amount of automobile physical damage claims insurance companies paid to New York consumers. Insurance Department data indicate that, in the 1994 calendar year, insurance companies paid $2.32 billion in automobile physical damage claims to New York claimants.[1]

Adjustment for Policy Deductibles - We based this adjustment on an average deductible amount of $300 times the estimated 900,786 collision and comprehensive claims insurers paid to New York claimants in 1994. We did not adjust for auto property damage liability claims because deductibles do not apply to those claims. The adjustment for deductibles totaled $270.2 million.

Adjustment for Tax Exempt Repair Services - Examples of exempt transactions include:

- repair services and replacement vehicles purchased by tax-exempt organizations;
- repair services and replacement vehicles purchased for production use by farms and manufacturers;
- repair services and replacement vehicles purchased for resale (e.g., rental car companies and automobile dealer vehicles held for sale); and
- exempt purchases related to certain trucks, tractors and tractor-trailer combinations.

In any of these exempt situations, insurers would not withhold and remit the Article 15 Tax. We estimated that 5.5 percent of insurance damage awards relate to exempt situations. This estimate was derived from the 1987 annual input-output accounts of the United States' economy, published in the Survey of Current Business.[2] The adjustment for tax exempt repair services equaled $132.6 million.

Adjustment for Sales Tax Component of Claims - We calculated the sales tax portion using a weighted average State and local sales tax rate of 7.8274 percent. The estimated amount paid in respect of sales tax on 1994 claims equaled $178 million.

Adjustment for Reimbursement to Claimants - The last adjustment, in calculating the tax amount insurance companies would withhold, related to claims paid to reimburse motorists for covered expenses they already paid. Based on information provided by advisory panel members, we estimated that 2.5 percent of insurance damage awards relate to reimbursement situations. This adjustment equaled $57 million.

Estimate of Revenue Gain

Taking into account these adjustments, insurance companies will withhold and remit to the State approximately $173.9 million in Article 15 tax. Working from that base, we estimated the tax's potential revenue. Calculating the revenue required us to account for several offsetting factors. The largest of these was current sales tax compliance. That is, we reduced our estimate of the potential revenue gain by the amount of sales tax the State currently collects from repair vendors. Other major adjustments related primarily to the Article 15 refund provisions.

Current Sales Tax Compliance on Repair Services - The single largest offsetting factor is the State and local sales tax the State currently collects on motor vehicle repair services covered by physical damage awards. We estimated that, in the 1994 sales tax year, the sales tax collected on insurance-related auto repair services was $103.9 million. We based this estimate on sales tax return information from vendors in the repair industry including auto dealers. We adjusted reported sales to account for the percentage of sales that would relate to physical damage claim awards by type of repair industry. The percentages were derived from information provided by advisory panel members.

Adjustment for Claims Where the Claimant Purchases or Leases a New or Used Replacement Vehicle - We believe that Article 15 will not produce any revenue gain when a consumer replaces his or her damaged vehicle.[3] Automobile dealerships have a good compliance record. In addition, the Department of Motor Vehicles requires proof of payment of sales tax before it will register a new vehicle.

Here we assumed that 20 percent[4] of the total amount of physical damage claims represent total losses and other situations where the claimant will replace the vehicle. Therefore, we reduced the estimate of the potential revenue gain from Article 15 by $34.8 million.

Adjustment for Out of State Repairs - DMV records indicate that 49 percent of the motor vehicles registered in New York State are registered in counties bordering other states or in New York City. From this information, we conservatively assumed that 5 percent of damage awards paid to New Yorkers are for repairs they will purchase outside New York. We also assumed that the average sales tax rate paid on repairs in other States equals 6 percent. Thus, the refunds generated by out of state repairs would offset the potential revenue gain from implementing Article 15 by an estimated $8.7 million.

Adjustment for Claims Where the Claimant Does Not Repair or Replace the Vehicle - Claimants receiving insurance damage awards may choose not to repair or replace the damaged vehicle. Article 15 provides that, in those situations, the claimant is entitled to a refund. Neither the insurance industry nor the Insurance Department representatives on the advisory panel could provide data regarding the percentage of damage awards that do not result in repairs. We assumed that claimants will request refunds for 10 percent of the amount of Article 15 tax insurers withhold. Therefore, our estimate of the potential revenue gain was reduced by $17.4 million.

Endnotes

1. Claims statistics are as reported to the Insurance Department. The statistics are unaudited.

2. Survey of Current Business, April 1994, Volume 74, Number 4.

3. This assumes that the tax due on a replacement vehicle will equal or exceed the value of the Article 15 tax stated on the voucher.

4. Assumption based on information provided by advisory panel members.

Appendix G: Estimate of Article 15 Costs

The following describes the methodology used to estimate the total costs Article 15 will impose on businesses and government.[1]

Insurance Industry

Article 15 will impose total first year costs on the insurance industry of approximately $42 million. In each subsequent year, the tax will impose estimated costs on the industry equaling $14 million.

In developing the industry cost estimates, we identified seven major differences between the costs insurance companies incur under current law and the costs they will incur under Article 15. Those costs included:

- developing and printing counterfeit-proof vouchers;
- re-programming computers to accommodate the Article 15 system;
- training claims representatives to collect information needed for processing claims;
- training customer service representatives to answer customer's Article 15 questions;
- filing monthly or quarterly sales tax returns;
- filing quarterly magnetic media reports; and
- undergoing Article 15 audits.

Some of the above costs depend largely on the volume of claims an insurer processes (variable costs). Companies will incur other costs regardless of the volume of claims they process (fixed costs). Most of the Article 15 implementation costs represent fixed costs.

The insurance industry designated the accounting firm of Coopers and Lybrand L.L.P. to work with us in developing the cost estimate for insurers. In developing the estimate, New York insurers were divided into four strata based on the amount of premiums they received from New York claimants. A sampling of companies in each stratum then provided Coopers and Lybrand L.L.P. with estimates of the costs Article 15 will impose for their companies. The sample results were then extrapolated to the entire population of companies writing automobile insurance policies in New York State.

Article 15 costs for the insurance industry will be offset, to some extent, by the "float" that insurers will realize on the tax component of damage awards. Currently, insurers pay the "sales tax" component to claimants when they pay the damage award. Under Article 15, insurers will withhold the tax component and remit it to the State on a monthly basis. The economic benefit to the industry of holding the funds for a longer time period will equal approximately $1 million annually.[2] The estimates of the total cost of Article 15 to the industry reflects this offsetting factor.

Motor Vehicle Repair Shop Industry

We estimate that Article 15 will impose total first year costs on the motor vehicle repair industry equaling approximately $6.9 million. In each subsequent year, the tax will impose estimated annual costs on the industry equaling $7.4 million.[3]

In developing the estimate, we identified and quantified four major costs Article 15 will immediately impose on the motor vehicle repair industry. The costs include:

- customer relations costs;
- costs associated with handling the vouchers and filing returns;
- cash flow costs; and,
- increased audit costs.

We estimated each cost component for the repair industry as follows:

Customer Relations Costs - Vehicle owners will not be familiar with the Article 15 tax until they experience an accident, theft or other covered incident. Consequently, they probably will have questions about the tax at some point during the vehicle repair process. Advisory panel members indicated that, on average, a motor vehicle repair shop will spend at least ten minutes explaining the voucher system to customers. At a rate of $40 per hour,[4] this represents an additional cost of $6.67 per voucher transaction. We assumed that motor vehicle repair facilities would handle 777,400[5] repair services involving Article 15 vouchers. Thus, the total customer relations cost will equal $5.2 million.

Costs Associated with Handling Vouchers and Filing Returns - Appendix A outlined the responsibilities that Article 15 places on motor vehicle repair shops, dealers and other vendors accepting vouchers. In consultation with the advisory panel, we conservatively assumed that motor vehicle repair facilities would spend an additional five minutes of clerical time per vehicle repaired to complete the voucher validation and the associated tax return schedules. Using an hourly rate of $8 per hour,[6] this represents an additional cost of 67 cents per voucher. Again, we assumed that motor vehicle repair facilities would handle 777,400 repair services involving Article 15 vouchers. Therefore, we estimated that the costs associated with handling vouchers will equal about $.5 million.

Cash Flow Costs - Article 15 will impose a cash flow cost on vehicle repair shops. We estimated that motor vehicle repair shops collect about $104 million in State and local sales tax from insurance related repair services. Currently, most motor vehicle repair shops file sales tax returns quarterly. This allows them to hold those sales tax funds for a period of 20 days to 120 days before remitting them to the State. The Article 15 tax eliminates this positive float for the amount of taxes represented by vouchers presented in lieu of paying sales tax.

To estimate the cash flow implications of losing the float, we assumed that repair shops currently hold sales tax funds for an average of 70 days. Assuming they could invest the funds at an interest rate of 5.816 percent,[7] repair shops will experience a recurring annual loss of approximately $1.2 million.

Audit Costs - The Article 15 tax adds a new dimension to motor vehicle repair shop audits. Moreover, it will require us to audit a greater number of repair shops. We assumed that the additional audit costs incurred by the industry would at least equal our additional costs to audit these businesses. Therefore, we estimated that the cost of undergoing audits for the motor vehicle repair industry will equal at least $.5 million.[8]

Motor Vehicle Dealerships

For the most part, dealers will incur costs similar to those the repair shop industry will incur, i.e., customer relations costs and costs associated with handling the vouchers and filing returns.[9] Using the cost assumptions outlined for the motor vehicle repair industry, and assuming that dealers would have 167,400 vehicle sales involving Article 15 vouchers, the first year estimated cost was at $1.2 million.[10] Subsequent year costs, which will include the additional cost of audits, will equal an estimated $1.4 million.

Department of Taxation and Finance

Article 15 will impose significant administrative costs on the Department of Taxation and Finance. A fully implemented system including an appropriate level of audit and enforcement activity will cost us approximately $4.2 million in the first year. In each subsequent year, the program will cost approximately $3.7 million.

We calculated the personnel service portion of the cost by estimating the staff time required for each of the described functions and multiplying that time by the average hourly rate of the staff devoted to the task. We added non-salary costs such as bank processing costs, auditor travel costs and the cost of additional computers for auditors.

The three major categories of costs Article 15 will impose on the Department will include: implementation costs; return and voucher processing costs; and additional audit costs.

Implementation Costs - We estimate that the cost of implementing Article 15 will equal approximately $500,000.[11] Implementing Article 15 will involve:

- identifying affected insurance companies, repair shops and other vendors;
- developing notices, regulations, forms, instructions and voucher specifications and distributing the materials to insurers, repair shops and other vendors;
- modifying sales tax return processing programs and developing programs for processing credit vouchers and quarterly magnetic media reports.

Return and Voucher Processing - We estimate that additional processing costs resulting from Article 15 will equal $1.2 million annually. These costs reflect the following:

- processing an additional 2,576 monthly sales tax returns and an additional 1,280 quarterly sales tax returns received from insurers;
- processing nearly 1,300 magnetic media files from insurers;
- data entering voucher information from approximately one million vouchers;
- matching insurance data and retail vendor data;
- bank processing;
- handling errors, exceptions and protests.

Increased Auditing - We estimate that additional audit costs resulting from implementing Article 15 will equal $1.5 million annually. This estimate reflects the increased cost of auditing the returns of insurance companies and motor vehicle repair shops to ensure compliance with the Article 15 requirements.[12]

The Department of Motor Vehicles and Offices of County Clerks

The Article 15 tax will impose implementation costs and recurring costs on the Department of Motor Vehicles. For example, a requirement to show the voucher amount on a registration receipt would require computer systems changes and forms changes. The Article 15 tax would also involve significant changes in accounting systems. Implementation and other first year costs for the Department of Motor Vehicles would equal $200,000.

Article 15 will also impose ongoing costs on Department of Motor Vehicles' District Offices and the Offices of County Clerks. We estimate that claimants would purchase about 72,000 replacement vehicles from private individuals.[13] In those cases, the motorist would present the Article 15 voucher at a Department of Motor Vehicles District Office or at a county clerk's office. The Department of Motor Vehicles believes that, on average, the Article 15 tax will add between two minutes and five minutes to the time it now takes to process a casual motor vehicle transaction. In addition, Motor Vehicle Representatives would likely need to spend additional time explaining the Article 15 system to DMV customers. Both factors would increase waiting time for customers and could add up to an additional $120,000 in annually recurring costs.

New York Residents

With Article 15 in effect, it will take more time for New York residents to repair or replace their vehicles. For example, some claimants will need to return their voucher to their insurers and obtain separate vouchers for each vendor that will work on the vehicle. In other situations, claimants may decide to return vouchers for refund because they are not going to repair or replace their vehicles. Compared to the current system, the voucher system will certainly prove less convenient and more time consuming than simply cashing or endorsing a check.

Because circumstances can vary greatly from claim to claim, it was very difficult for us to estimate the additional time it will take motorist to deal with the complications Article 15 will present. In quantifying the cost of Article 15 to consumers, we used a conservative estimate that the additional time per claim will equal at least 30 minutes. Based on that assumption, we calculated that the cost of Article 15 to consumers will equal at least $7 million annually.[14]

Endnotes

1. Article 15 would apply to many transactions not normally considered to be within the motor vehicle repair industry or a related industry. For example, Article 15 encompasses repair parts purchased by claimants who repair covered vehicles themselves. Vehicle parts are available from a variety of retailers ranging from auto salvage yards and auto parts discount stores to grocery stores, hardware stores and general merchandise stores. Furthermore, the Article 15 voucher system also applies to covered damages to motorcycles, snowmobiles, all-terrain vehicle and trailers. We were not able to estimate the costs of Article 15 for businesses which sell or repair these other types of vehicles.

2. In estimating the benefit of the float, we assume insurers would hold the funds for an average of 35 additional days. We also assume that the annual rate of return on investing the funds will equal 5.816 percent (the interest rate earned by the State Comptroller, for November 1995, on funds in the short term investment pool).

3. Because of the cost of undergoing audits, the cost will be higher in the second and subsequent years.

4. Industry representatives indicated that, in most instances, the repair shop owner will need to explain the Article 15 provisions. In estimating this cost, we used a rate of $40 per hour (the average repair shop labor rate as reported by the New York State Auto Collision Technicians Association).

5. We based the estimate on the number of claims subject to Article 15 less estimated claims where the claimant will replace the vehicle.

6. Based on the 1994 national average hourly wage for retail employees as reported by the United States Department of Commerce, Bureau of Labor Statistics.

7. The rate earned by the State Comptroller on investments in the short term investment pool.

8. This assumes that repair shops and dealers are audited in the same proportion based on the number of vendors in each industry.

9. Due to vehicle sales, the majority of new car dealers file sales tax returns on a monthly basis, or, if participating in the electronic funds transfer program, twice monthly. Therefore, they currently receive less cash flow benefit from the sales tax than vendors that pay tax quarterly.

10. We assumed 20 percent of the 1.2 million Article 15 claims transactions will involve total losses. We also assumed that claimants would purchase or lease 70 percent of the replacement vehicles from a dealer.

11. This estimate includes only the additional cost incurred from implementing Article 15. The Department has already expended approximately $500,000 in implementing the tax. We expended most of that money in 1991 before the court injunction halted implementation of the tax.

12. This estimate covers the cost of 24 auditors and appropriate support staff and equipment for the increased time to conduct Article 15 audits: 12 auditors assigned to audit repair shops and other vendors, 10 auditors to audit insurance companies and 2 auditors to review claimant refund applications.

13. The estimated 72,000 private vehicle purchases assumes that 20 percent of the 1.2 million Article 15 transactions will involve total loss transactions. We also assumed that claimants will purchase 30 percent of replacement vehicles from private individuals.

14. The 1994 national average hourly earnings for production or nonsupervisory workers equaled $11.12 per hour (United States Department of Commerce, Bureau of Labor Statistics). The estimated number of claims equals 1.3 million (based on 1994 claims as reported by the New York State Insurance Department). The 30 minute estimate assumes 10 minutes to read and understand Article 15 information and instructions provided by insurers and 20 minutes added to the time spent filing claims, requesting refunds, and arranging for vehicle repairs or replacements.

Appendix H: Description of Sales Tax Data

The Sales Tax Returns Data Base

We based our profile of New York's motor vehicle repair service industry on information it compiled from 1993-94 sales tax returns.

The sales tax returns data base includes information from the sales tax periods June 1, 1993, through May 31, 1994. It contains data for all sales tax vendors the Department identified as being in the motor vehicle repair industry which filed at least one return during the year. The analysis contains information from the most current returns filed for that year. To the extent that vendors filed amended returns, the analysis reflects the new information. Taxable sales information reflects the tax vendors reported as due during the period.

The data base reflects taxpayer reported liability for the period, not actual cash collections. Where a vendor did not pay all of the tax due, or paid additional monies (e.g., previously due interest) the analysis does not reflect the differences. In other words, the data base reflects the amount of tax which should have been remitted with the return based on the reported taxable sales. In cases where a taxpayer did not file all returns due for a given period, its liability for the missing period is deemed to be $0.

The Definition of a Sales Tax Vendor

Our industry description is based on information about sales tax vendors. The definition of vendor can make interpretation of the analysis somewhat difficult. For example, a vendor may consist of a single company operating one repair facility or a single company operating a chain of repair facilities.

Companies with more than one location have two options for filing tax returns. One option is to file a consolidated return. When filing a consolidated return, a company combines all sales, purchases and tax from all business locations onto one tax return. The locations then appear in the industry description as one taxpayer.

A company's other option is to file a separate tax return for each location. In this case, the same company may file numerous returns, each appearing much smaller than the company would on a consolidated return. For example, if filing separate returns for each repair facility, a single large repair service provider with numerous facilities appears on the data base as many smaller sized taxpayers.

Industry Classification

The sales tax vendor data base classifies vendors into various industry categories. Vendors are placed in specific industry categories on the basis of a business description which they provide when they apply for a Certificate of Authority. As part of the application process, applicants assign a general and specific "business description code" describing their primary business activity. For the most part, the business description codes are based on the Standard Industrial Classification coding system created by the U.S. Department of Commerce.

Industry codes appearing in the data base have not been verified. The data base relies strictly on the descriptions made by the taxpayer at the time of registration. The data base has not been revised to account for apparent business code misclassifications.

Description of Tax Liability Data

We obtained the tax liability information for this report from the sales tax returns of repair vendors. Tax liability information represents the amount of sales tax that a vendor reports owing in a particular quarter. In other words, it reflects the amount of tax which the vendor should have remitted with the return based on the reported amount of taxable sales. For example, if a return reported a tax due of $5,000 and the vendor remitted $3,000 with the return, the data base would show a tax liability of $5,000. Furthermore, the tax liability data eliminate distortions caused by late payments, audit revenues, penalty and interest payments and any prior period adjustments (e.g., changes made to accommodate amended returns, refunds, protested checks, audits and various other administrative factors).

Tax liability data contain information from the most current returns filed. They pertain to the period in which the sales were reported rather than the period when the revenue was remitted by the vendor or distributed to the various government funds or local government units. To the extent that amended returns were filed, the data contain the new information.

Every attempt was made to ensure the accuracy of the tax liability data provided in this report. However, a number of limitations exist. Foremost, these data reflect what taxpayers reported on tax returns. Tax returns which contained errors and/or returns which involved discrepancies may not be included in the sales tax data base. Additionally, the data base file may contain undetected preparation or clerical errors. Finally, the sales tax returns data base is continually updated to reflect late payments, amended returns, audit changes and missing industry identification codes.