REPORT OF THE
JOINT LEGISLATIVE
AUDIT AND REVIEW COMMISSION

Review of the Department of Taxation

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 49

COMMONWEALTH OF VIRGINIA
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Preface

Item 13 of the 1991 Appropriation Act directed JLARC to review the organization, management, and operations of the Department of Taxation. The study focused on the effectiveness and efficiency of the department's compliance revenue collection efforts.

JLARC staff estimate a "tax gap" of more than $500 million in corporate and individual income taxes that is owed but not paid the Commonwealth each year. Further, staff estimate that the department could annually collect approximately $150 million of this amount over the long term by utilizing more systematic, timely, and innovative collection techniques.

The report also presents evidence which indicates that additional revenue could be collected with improved management. In FY 1991, the department could have collected more than $10 million in additional revenue by more efficient use of compliance staff.

Over the years, many recommendations by other State oversight bodies have gone unheeded by the department. Greater oversight of the department is needed to improve responsiveness and accountability.

Some of the recommendations for closing the State's tax gap will require the department to implement pilot programs to systematically identify and address areas of non-compliance. These actions will require additional time. However, other recommendations could be addressed immediately. The Commission, in recognition of the complexity of the issues covered in the study, has appointed a sub-committee to continue work on the issues presented in this report.

The Senate Finance Committee requested that the department work with JLARC staff and the Auditor of Public Accounts to determine a conservative estimate of the additional revenue the department can collect during the 1992-1994 biennium. The administration has initially estimated that the department can collect an additional $40 million net of its new costs. As this report goes to press, the department is developing a plan for collection.

On behalf of JLARC staff, I would like to thank the Secretary of Finance for his cooperation during the study. Further, I would especially like to thank those employees of the Department of Taxation whose desire to help make the department a better organization resulted in their candid and thoughtful responses to our interview questions and surveys.

Philip A. Leone
Director

January 30, 1992

JLARC Report Summary

REVIEW OF THE DEPARTMENT OF TAXATION

January 1992

Joint Legislative Audit and Review Commission

A Report In a Series On the Executive Budget Process

Virginia's tax system, like the federal system and other state systems, relies heavily on voluntary compliance. Voluntary compliance assumes that taxpayers voluntarily report and pay the correct amount of taxes due. However, JLARC staff estimate that Virginia filers underreported their true tax liabilities by more than $400 million in 1989.

The Virginia Department of Taxation was created in 1927 to administer the State's tax system and is currently responsible for administering 20 State taxes. The revenue collected by the department for these taxes serves as the largest source of revenue for the Commonwealth.

The tax commissioner oversees the tax department, a large and complex organization with an appropriation of $46.6 million and more than 845 staff during fiscal year 1992. The *Code of Virginia* empowers the department and the tax commissioner with broad authority regarding the administration of State taxes. The department is able to both determine tax liability through assessments and to reduce or eliminate the amount owed through abatements, write-offs, and discharges. Although these decisions can significantly affect the State's revenue collections, the department is not statutorily required to have these decisions reviewed by any outside source.

The mission of the department is "to efficiently and effectively administer the tax laws assigned to its responsibility by the *Code of Virginia*." The department addresses its mission primarily by attempting: (1) to encourage the highest level of voluntary compliance and (2) to collect the correct amount of revenue due the State. The department encourages voluntary compliance through its services to taxpayers. Data from a recent statewide household survey indicate that 86 percent of the individuals who have used the services of the department were satisfied with them.

The department seeks to collect the correct amount of taxes through its compliance revenue collections activities. However, in the same survey of households, more than 17 percent of the respondents indicated that they personally knew at least three individuals who are underpaying their true State tax liabilities. Such knowledge can, over time, undermine the belief that the tax system is equitable and fair, which may further reduce voluntary compliance in the State.

Item 13 of the 1991 Appropriation Act directed JLARC to review the organization, management, and operations of the Department of Taxation. Given the complexity of the organization and the current financial position of the State, the scope of this review was a general management and organization review which focused on improving collections and compliance activities of the department. The findings contained in this report have substantial financial implications for State government. The report identifies new collections strategies which over time could potentially produce approximately $154 million annually in additional collections.

Further, improvements to current collections activities conducted by the department could have produced more than $10 million in additional revenue in FY 1991. It is impossible to calculate with any certainty the revenue that has not been collected due to several other shortcomings in the collections activities conducted by the department. However, the changes recommended in these areas, if implemented by the department, could also produce significant increases in future collections.

This report summary briefly references study findings and recommendations. Detailed explanations and discussion are contained in the text of the report.

Virginia's Tax Gap Estimated to Be More than $512 million By 1992

The U.S. Internal Revenue Service (IRS) and many state tax departments have computed estimates of the difference in what they are collecting and what taxpayers actually owe. These differences are commonly referred to as "tax gap" estimates. These estimates have three basic components:

- reporting tax gap — the difference between actual tax liability and amount voluntarily reported by filing taxpayers as due.
- remittance tax gap — the difference in the amount taxpayers voluntarily remit and the amount they actually owe.
- non-filer tax gap — the amount owed by individuals and businesses who do not file returns.

The Virginia Department of Taxation has not computed a tax gap estimate for Virginia. Such an estimate is a needed performance measure which can be used by the department to improve goal setting, target compliance activities appropriately, and internally monitor the department's performance. Further, the tax gap estimates can be used by the House and Senate Finance Committees and the House Appropriations Committee in providing external oversight of the department.

JLARC staff estimate that Virginia's "reporting tax gap" — the difference in what individual and corporate taxpayers voluntarily report on their returns and the taxes that they actually owed the State — was more than $405 million in 1989. Assuming that the State tax gap increases at the same rate as the federal gap, JLARC staff project that the difference will be more than $512 million by 1992.

Information needed to compute a remittance tax gap and a non-filer tax gap estimate for a given year was not available. However, a cumulative remittance gap is evidenced by the department's accounts receivable inventory of $404 million. The recently completed tax amnesty program provides further evidence of a correctible remittance problem as the department reported that $11 million of the $32 million collected was from the existing accounts receivable inventory.

The goal of closing the tax gap is not simply one of collections; perhaps more

FINANCIAL IMPLICATIONS OF STUDY FINDINGS

Sources of Revenue	Estimate	Potentially Collectible*
1992 Reporting Tax Gap	$512 million	$154 million
Cumulative Remittance Gap	$404 million	Unknown
Non-Filer Gap	Unknown	Unknown

*Based on IRS estimate of collectibility.

Increased Revenue From Improvements to Collections Activities	
Better Utilization of Compliance Staff	$10,091,340
Direct Deposit by District Office	$122,997
Timely Conversion of Business Assessments	$261,784
Potential Additional Revenue, FY 1991	**$10,476,121**

Other Financial Implications	
Accurate Reporting of Compliance Revenue	$43 million
Better Setting of Compliance Revenue Goal	Unknown
Improvements to Assessment Quality	Unknown
Improvements to STARS	Unknown

important are the goals of taxpayer equity and promoting confidence in the State's tax system. The collection of taxes due from all entities should help increase taxpayer confidence in the State's tax system.

The following recommendations are made:

- The Department of Taxation should refine the JLARC reporting tax gap estimate. The department should estimate total gross and net tax gaps every two years. The department should include sales and use tax and the larger miscellaneous taxes in its estimates. Progress in closing the gap should be reported annually to the House and Senate Finance Committees and the House Appropriations Committee.

- The department should review tax gap estimation methodologies used by the IRS and other state tax departments and the strategies used by these agencies to close their tax gaps.

- The department should begin to analyze its abatement data to better determine the reasons for abatements, to better collect assessments, and to reduce the percentage of abated assessments.

- The department should begin to better analyze its accounts receivable inventory. The department should use its analysis to: (1) develop a collectibility assessment of the inventory; (2) develop guidelines and priorities for collecting the accounts receivable; and (3) experiment with and track the success of various methods of collections.

- The department should fully analyze the information from its tax amnesty program to better focus its collection of the State's remittance tax gap.

Unclaimed Withholding in 1989 More than $140 Million

The JLARC calculations of the reporting tax gap include more than $140 million of revenue from unclaimed over-withholding. Some unknown portion of this revenue may not be due the State. As Virginia moves to accurate withholding, currently planned for January 1, 1993, this revenue will no longer be collected. Therefore, total collections may decrease.

This change in withholding will result in a change in taxpayer behavior. More Virginians will need to pay additional taxes with their returns than do now. Currently, the majority of Virginia filers receive refunds. As of August 1991, the department had not begun planning how to modify their current collection strategies to address this change.

The following recommendations are made:

- The General Assembly may wish to consider amending § 58.1-642 of the *Code of Virginia* to delay the implementation of accurate withholding.

- The department should develop strategies to collect taxes from individual taxpayers under a system of accurate withholding.

Department Compliance Revenue Goal Not Appropriately Set

Each year the department establishes its annual compliance goal and works to achieve that goal. The department does not use estimates of what could be collected (such as information from tax gap estimates) but establishes the goal primarily on prior year collections. This establishes the goal lower than it would be if tax gap estimates were used.

The department periodically reports to the Secretary of Finance on the status of goal attainment. During 1991, the department counted and reported revenue, voluntarily paid by taxpayers but received late by the department, as compliance revenue. Compliance revenue is generally revenue which has resulted from enforcement actions, not from processing late payments. More than $43 million of the $240 million reported by the department as compliance revenue was from late payments. Reporting such revenue as compliance revenue overstates the effectiveness of the department's compliance enforcement activities.

The following recommendations are made:

- The department should revise its methodology for setting its compliance revenue collections goals. The department should base its goal on estimates of outstanding tax liabilities due the State.

- The department should include only those collections which result from direct enforcement actions by the department as compliance revenue.

Department Routinely Uses Compliance Staff to Provide Services to Taxpayers

The department has approximately 51 staff dedicated to providing taxpayer assistance. However, the department routinely uses compliance staff, earning an average of $29,000 annually, to provide these services to taxpayers. These services include helping taxpayers fill out forms and resolve problems resulting from department processing errors.

Using department estimates of productivity, compliance staff did not assess and collect more than $10 million in taxes due to time spent providing taxpayer assistance. This is an extremely conservative estimate since it is based only on the 287 district office compliance staff. The department does not maintain information necessary to estimate time spent on activities for the remaining 130 compliance staff assigned to the central office.

The following recommendations are made:

- The department should not routinely use field representatives and auditors to provide taxpayer assistance.
- The department should improve its capability to identify and correct tax return errors before a notice is sent to the taxpayer. Taxpayer assistance with these errors should be provided by taxpayer assistance personnel.

Department Needs to Improve Its Audit Assessments

Although the Department of Taxation has an audit manual, the department does not appear to have a formalized strategy for selecting returns for audit. Instead, the department relies on federal data and individual auditor judgement to select audit candidates. Federal data have limitations which adversely affect the quality of audit selection. In addition, the department does not receive the federal data until nearly two years after the tax liability has been incurred by the taxpayer.

The department relies on individual auditor judgement to select corporate and sales and use returns for audit. This results in the selections being inconsistent and subjective. The department needs to develop and use standard selection criteria to select corporate and sales and use audit candidates.

In addition, the department does not have standard procedures to ensure that quality audits are being performed. The department relies heavily on auditor discretion and cannot be certain of consistency and objectivity in the performance of the audits.

The following recommendations are made:

- The department should pilot test using selected Virginia data to supplement federal audit information. The department should analyze the pilot information to determine collectibility.
- The department should establish standard and objective criteria for selecting corporate returns for audit.
- The department should establish and implement a retail sales and use tax audit selection strategy which is consistent and not subjective.
- The department should develop standards for audit procedures.

More Non-Filers Could Be Identified Using Available State Data

The department does not sufficiently use available State data to determine non-filers. The department relies on federal data to determine individual non-filers and relies on voluntary tax registration information to identify business non-filers. Other states have been able to use State data to identify non-filers and collect revenue from them. Virginia has many sources of data which could be used for this including: motor vehicle registrations, driver's license registrations, professional boards, and employer registrations maintained by the Virginia Employment Commission (VEC) and the State Corporation Commission (SCC). The department needs to begin to examine these data and use them in innovative and creative ways to identify non-filers.

The following recommendations are made:

- The department should continue to use federal data to identify non-filers. However, the department should examine the feasibility and cost effectiveness of computer matches with State databases to identify and locate additional non-filers. Databases should include those maintained by the Department of Motor Vehicles (DMV), SCC, VEC, and professional registrations maintained by the State.

- The department should prepare and implement strategies for systematically matching data in the business tax registration database with data from VEC, SCC, and other appropriate State agencies. The department should develop a systematic approach to evaluate the available data, the costs of matching, and the potential additional revenue from each source.

Better Monitoring of Collections which Result from Assessments Is Needed

The department does not adequately monitor its assessments. This lack of monitoring has resulted in the department: (1) overstating by more than 13 percent the collections which result from assessments made in 1989; (2) not being able to sufficiently monitor the quality of its assessments; and (3) during the last three years not converting more than $1.9 million in business assessments to individual liabilities.

The following recommendations are made:

- The department should track the current status of all tax assessments. The total amount of assessments which have been collected, abated, or discharged should be monitored. This information should be used to evaluate quality of assessments and collections activities.

- The department should ensure that all uncollected business tax assessments are converted prior to the expiration of the three year statute of limitations.

STARS Beneficial to Department but System Limitations Need to Be Addressed

The State Tax Accounting and Reporting System (STARS) was developed by the department to improve its abilities to process tax forms and better collect compliance revenue. The department is justifiably proud of its accomplishments due to implementation of STARS.

While STARS has improved the efficiency of the department, the system appears to have significant limitations which have lessened the effectiveness of the department's collections. It was not possible to determine if these limitations are due to technical deficiencies in the system or are the result of inefficient utilization of the system.

STARS is limited in its usefulness in collecting business taxes. Businesses can have multiple tax accounts at the department. Staff have not entered data necessary to link multiple accounts for many businesses. Further, even for the businesses for which the staff have entered the appropriate data, STARS is not programmed to link these multiple accounts for the same business. Therefore, tax refunds can be made to businesses which actually owe taxes to the State at the time of the refund. In addition, STARS does not allow business taxes to be "written off". Write-off capability would allow the department to suspend active collections while keeping the account in the refund set-off program for possible future collection. Instead, business taxes must be discharged which means that they are removed from the refund set-off program and eliminated from possible future collection.

The following recommendations are made:

- The department should enter the necessary data and modify STARS programming to ensure that all account balances for businesses are paid before refunds are issued.

- The department should modify STARS programming to accommodate "write-off" capabilities for businesses.

State Losing Interest Income from District Office Collections

Revenue collected by the eight district offices cannot be deposited locally. Instead, these funds must be sent by courier to the central office in Richmond for processing and deposit. According to department staff, STARS is not programmed to allow direct deposit by district offices. JLARC staff estimate that the inability to deposit these payments directly may have cost the State approximately $122,997 in lost interest during FY 1991.

The following recommendation is made:

- The department should modify its procedures to enable district offices to make local deposits of State tax payments.

Department Needs to Reassess STARS

The department needs to fully ascertain its needs and uses for STARS. When STARS was implemented, the major concern was being able to process large amounts of data fairly quickly and easily. However, department staff are beginning to identify the need for computerized management reports which STARS is not able to provide efficiently. The department should determine the deficiencies in the current system and the long range needs of the department. In examining these needs, the department should utilize the suggestions of department staff regarding requested changes.

The following recommendations are made:

- The department should ensure that the information systems division consider and implement appropriately employee suggestions that have a direct and cost-effective impact on compliance collections.

- The Secretary of Finance or the department should request that the Department of Information Technology (DIT) conduct a systems analysis of STARS to address the current deficiencies in the system and to determine long range requirements.

Functional Organization Generally Sound but Recommended Changes Could Improve Operations

The functional organization of the department appears to be more efficient than organizing based on type of tax administered. However, three changes could be made which could allow the department to function more efficiently and effectively.

First, the deputy commissioner position should be filled. Given the size of the department, the importance of its function to State government, and the complexity of its responsibilities, it is imperative that the department have a recognized second in command.

Second, the department should be somewhat reorganized. The purpose of the reorganization would be to eliminate the large number of small administrative units and to eliminate having two different divisions responsible for audit functions and having two different divisions responsible for collections. This should provide for a more collegial and less competitive approach to audits and collections.

Third, it appears that staff could be better utilized. Many of the staff stated, and examination of their work assignments supported the assertions, that the workload was unmanageable. Other staff indicated that they usually had less than a full day's work to keep them occupied. Further, the department has been receiving additional auditor positions during this fiscal year. No apparent rationale has been followed by the department in placing these staff.

The following recommendations are made:

- The department should fill the deputy commissioner position.

- The department should restructure its operations to accommodate filling the deputy commissioner position, to reduce the number of assistant commissioners to two, and to address organizational weaknesses. The reorganization should eliminate two different divisions having responsibility for audit activities and for collections activities.

- The department should review all currently established positions to ensure that work responsibilities are commensurate with employee abilities and time.

- The department should limit the number of delinquent individual tax accounts that are sent to the district offices. If these accounts accumulate, they should be handled by central office and additional delinquent business accounts should be sent to the district offices.

- The department should involve the district office supervisors in the decision-making regarding the assignment of audit and collections staff. In assigning staff, the department should consider the availability of office space and support staff and the revenue potential in the district offices.

- As part of the department's strategic planning process, the department should examine the physical working conditions in the district offices and the effect of those conditions on productivity.

- The department should develop a preliminary staffing plan which indicates the number of staff necessary to implement additional collections activities recommended in this report and estimates revenue which would be collected. The plan should be submitted prior to the 1993 Session of the General Assembly.

- The Secretary of Finance should direct the Department of Planning and Budget (DPB) to complete a comprehensive evaluation of the staffing needs and personnel practices of the Department of Taxation.

- As a function of its reorganization, the department should review the position description for each management position and establish that each management position is needed and that there are no unnecessary levels of management.

Identified Management Weaknesses Need Correction

The review identified three management weaknesses which appear to be hampering effective operation of the department. These areas need to be addressed by department management and steps taken to improve them.

First, the department's strategic plan is limited in scope, giving insufficient attention to compliance functions and the resources needed to maximize revenue collections. Attention should be given to estimating the State's tax gap and planning efforts to close the gap. In the absence of a well-developed strategic plan, the department's planning activities generally have been completed on a compartmentalized, as-needed basis. The department needs to develop a strategic planning process that integrates changes in Virginia's population, economy, and taxpayer assistance with changes in technology, staffing, policy, and information needs. These trends and changes should be related to department operations to determine what impact they will have.

Second, the department lacks sufficient controls to prevent fraud and disclosure of confidential tax information. The department needs to better limit STARS screen access as the Auditor of Public Accounts (APA) has recommended each year since 1986. In addition, the department could conduct initial and periodic background investigations of employees. Tax departments in 14 of the 18 other states contacted conduct background investigations on staff as do 19 other State agencies in Virginia. These investigations are necessary given the revenue affecting decisions made by these employees.

Third, it does not appear that the department management adequately addresses employee concerns which can affect department operations. Staff indicated that morale, salary levels, communication, management, and leadership were the most problematic aspects of the agency's operation. Such negative perceptions can adversely affect department productivity.

The following recommendations are made:

- The department should develop a strategic planning process that takes an integrated, comprehensive approach to planning for the agency. As part of this planning process, the State's tax gap should be estimated and strategies for closing the tax gap should be developed. The deputy director should be assigned responsibility for overseeing the process and developing and monitoring the plan.

- The department should develop an equipment replacement schedule.

- The department should follow the APA recommendations to review STARS access and limit that access as necessary.

- The department should work with the Office of the Attorney General and the Department of Personnel and Training (DPT) to establish policies and procedures for conducting initial and periodic background investigations of employees.

- The General Assembly may wish to amend the *Code of Virginia* to require the department to complete initial and periodic background investigations of its employees.

- The Secretary of Finance should ensure that the department implements the recommendations made by other oversight agencies such as the APA, Department of General Services (DGS), and the State Internal Auditor in a timely manner.

- The department should identify and implement approaches to address employee concerns and ideas.

Department Needs to Ensure Better Internal Accountability

Given the possible effect of department decisions on State revenue collections, it is imperative that the department maintain high standards of internal accountability. During this study JLARC staff examined more than 500 computer and hard copy tax files. This examination indicated that the department lacks necessary standards to guide documentation of decisions and staff decision-making on revenue affecting decisions, relies heavily on judgments of individual staff, and generally maintains inadequate documentation to support the decisions which were made.

For the majority of decisions made by the department there are no statutory directives for documentation. However, the department is required by Section 58.1-105 of the *Code of Virginia* to maintain certain documentation for accepted offers in compromise. Review of a sample of department files on these offers indicates that the department is not in compliance with the statutory requirements which direct that all evidence on these offers be maintained. A majority of the files reviewed had not sufficiently documented evidence that verified taxpayers' claims.

The following recommendations are made:

- The department should ensure that determination of doubtful collectibility is properly substantiated prior to accepting an offer in compromise as required by Section 58.1-105 of the *Code of Virginia*. At a minimum, the department should obtain and review a financial statement on the taxpayer.

- The department should take immediate steps to ensure that complete and accurate documentation is provided for all adjustments for which the department requires supporting documentation. The department should work with the APA to develop the documentation standards.

- The department should establish written procedures for audit documentation.

Additional External Oversight of the Department Is Needed

The department is granted broad authority for determining tax liability. The department can increase liability through assessments and can decrease or eliminate liability through abatements, discharges, or write-offs. Further, the department decides taxpayers' appeals resulting from department findings. There are no requirements for external review of the department's decisions. Therefore, other than through legal recourse, the department determines tax liability in Virginia.

Many of the department's decisions were reviewed during the course of this study. Several of these decisions, based on available documentation, appeared questionable.

Further, the department is abating large amounts of its assessments. This is especially apparent with larger assessments. A review of a sample of 30 of the largest assessments showed that the department originally assessed more than $28 million, collected $8 million, and abated more than $12 million. This is a small sample of the total number of assessments made by the department. However, the effects on revenue collections of abatements of this size indicate that additional review of large assessments is warranted.

Other states have more oversight of their tax departments than does Virginia. Eleven of the 18 states contacted had either independent review boards to hear taxpayer appeals or multiple commissioners overseeing the department.

It appears that Virginia's tax department should receive additional oversight given the importance of tax revenue to the State, the department's lack of documentation of decisions, and the questionable decisions identified in this report. There are a variety of oversight options which can be considered. These include establishing an independent review board, employing multiple commissioners, imposing additional reporting requirements, and providing dedicated staff to the Secretary of Finance for department oversight.

The following recommendations are made:

- The General Assembly may wish to amend Section 58.1-105 of the *Code of Virginia* to require the department to submit documentation to the Secretary of Finance of any downward adjustment of more than 25 percent on any assessment larger than $200,000.

- The General Assembly may wish to require the APA, as part of its annual review of the department, to review the documentation for downward adjustments of more than 25 percent of assessments of more than $200,000.

- The General Assembly may wish to further examine options for increased external oversight of the Department of Taxation.

Table of Contents

I. Introduction

The Virginia Department of Taxation was created in 1927 to administer the State's tax system. The department currently administers 20 taxes and provides assistance to other State and local entities on eight additional taxes. The administration of these taxes is discussed in this chapter.

Item 13 of the 1991 Appropriation Act directed JLARC to review the organization, management, and performance of the department. The full text of the mandate is contained in Appendix A. In addition to the legislative mandate, the Secretary of Finance met with JLARC staff early in the process to discuss study issues. Because of the JLARC study, the Secretary suspended a planned administration review of the department and suggested issues for the JLARC review. Given the complexity of the organization and the current financial position of the State, the scope of this review was a general management and organization review which focused on improving collections and compliance enforcement activities of the department.

OVERVIEW OF AUTHORITY AND RESPONSIBILITIES

The tax department serves as the primary generator of revenue for the Commonwealth. In fiscal year (FY) 1991, the department collected more than $5.2 billion in taxes due the State. In FY 1992, the department has a budget of $46.6 million and a maximum employment level of 929 to administer the State's tax system.

The *Code of Virginia* empowers the tax commissioner and the department with the authority necessary to administer the State's tax system. The tax commissioner is granted broad decision-making authority regarding the administration of State taxes, which can greatly affect revenue generation in the State.

Taxes Administered

Taxes administered by the Department of Taxation can be grouped into four broad categories: individual income taxes, corporate income taxes, retail sales and use taxes, and all other taxes. Each of these taxes has its own particular tax base, rates, and exemptions.

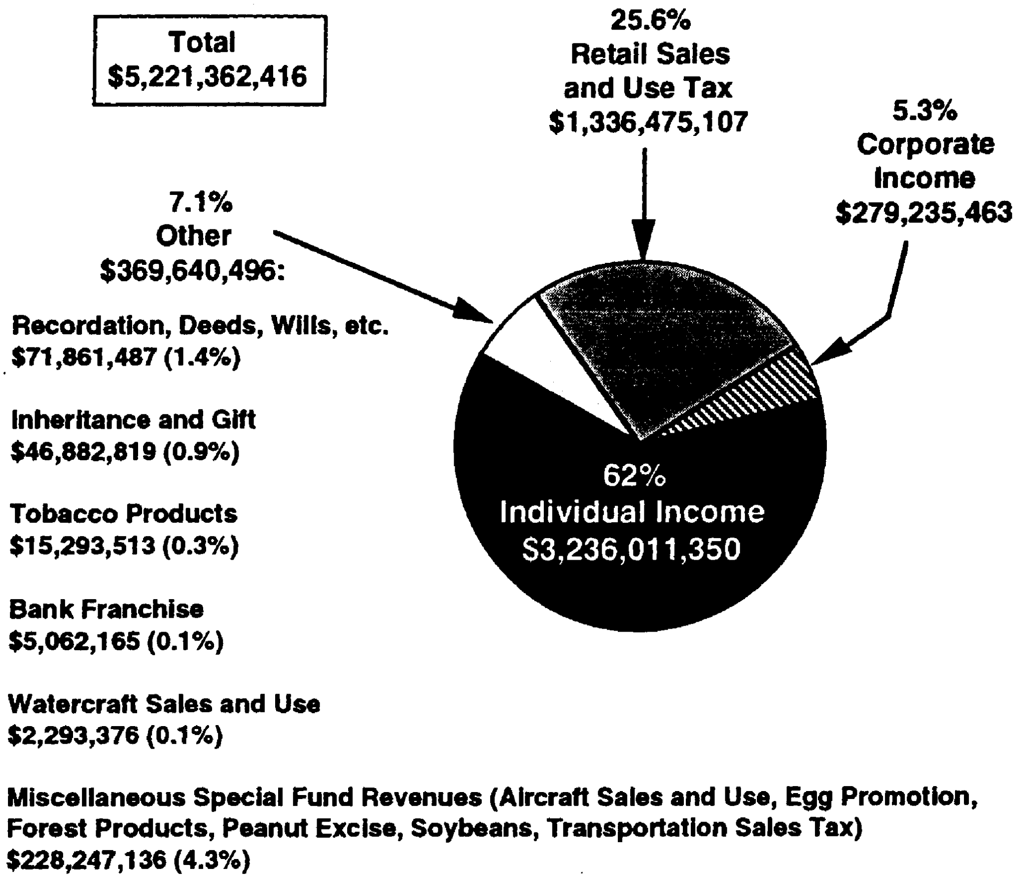
In general, statutory responsibilities of the department for the administration of these taxes involve issuing appropriate regulations, designing forms, processing taxes paid, assessing if the proper amount of tax has been paid, and assessing and collecting any additional amounts due. Appendix B contains the department's statutory responsibilities for each of the taxes which it administers.

Individual Income Tax. Individual income tax is the largest source of revenue collected by the Department of Taxation. This tax includes payments for individual estimated income, fiduciary income, and partnership income. It accounts for 62 percent of the total tax revenue collected (Figure 1). During fiscal year 1991, the department collected more than $3 billion from individual income tax. Taxes are paid to the department through withholding by employers during the tax year, payments by individuals during "tax season", and estimated payments by individuals throughout the year.

Local commissioners of revenue and treasurers have significant statutory responsibilities for administering this tax (Figure 2). Instructions on individual income tax returns direct taxpayers to file returns with local commissioners of revenue unless the local commissioner wants the returns to be directed to the State tax department. In fact, 50 percent of the returns in 1990 and 1991 were filed directly with the Department

Figure 1

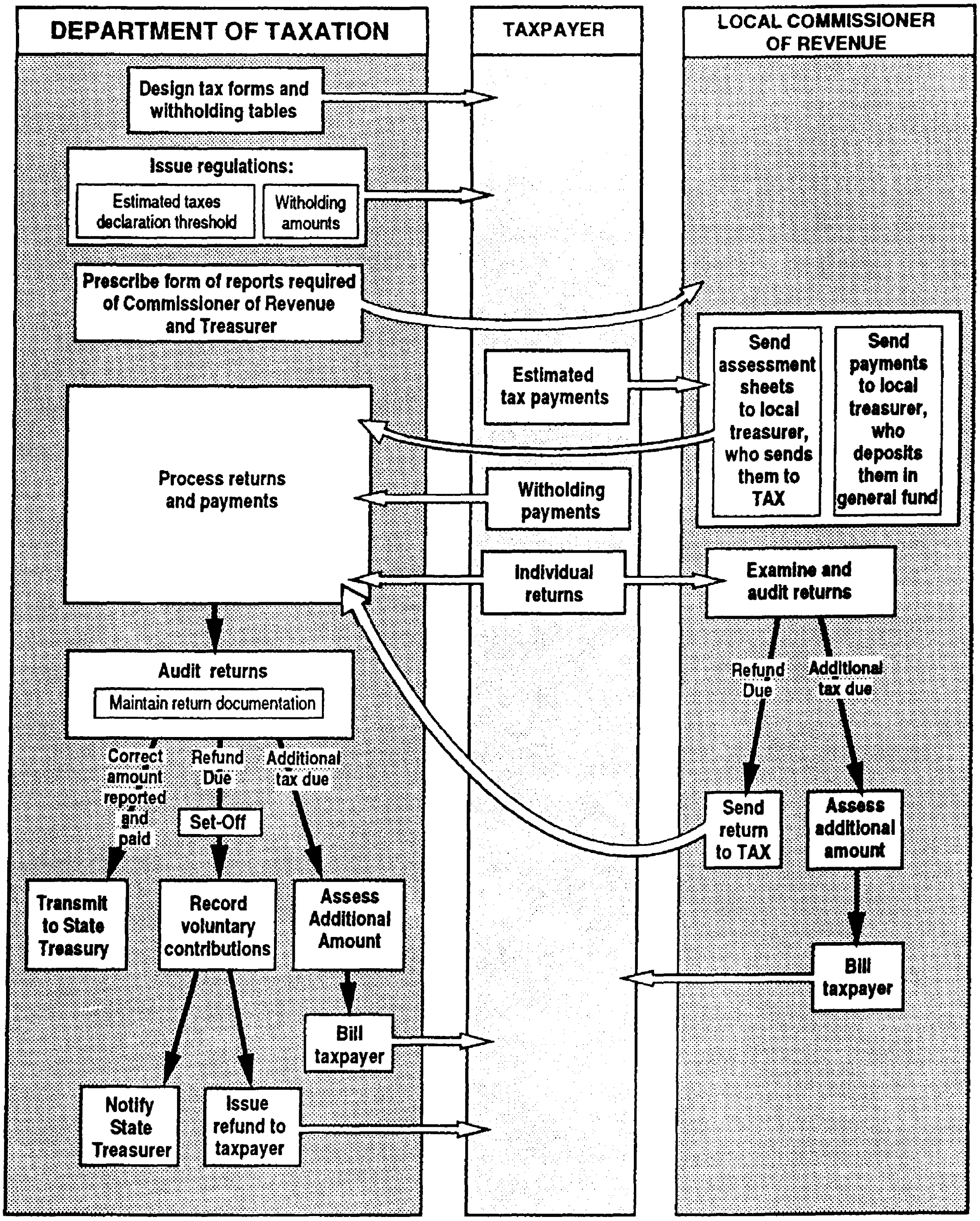
Department of Taxation Revenue Collections
Fiscal Year 1991



Source: JLARC analysis of Department of Taxation Data.

Figure 2

Department of Taxation's Statutory Responsibilities for Individual Income Tax Return Processing



Source: JLARC staff graphic based on information from the *Code of Virginia.*

of Taxation. For those filed locally, the commissioners of revenue are required to examine returns, to bill taxpayers for additional tax liability, and to then send all returns to the Department of Taxation for processing. Local treasurers deposit tax payments directly into the State treasury.

Retail Sales and Use Tax. The retail sales and use tax is the second largest source of revenue collected by the Department of Taxation. This tax source accounted for more than $1.3 billion or almost 26 percent of all collections made by the department in FY 1991.

There are two components to this tax and both are generally paid monthly to the department. The first, retail sales tax, is assessed on the sales price of each item of tangible personal property sold at retail or distributed in Virginia. The tax is also assessed on the gross proceeds derived from the lease of tangible personal property or on the cost of each item of tangible personal property stored in Virginia for consumption within the State. There are numerous exemptions to the sales tax.

The second component is the consumer's use tax, which is assessed on the cost of tangible personal property purchased outside Virginia but used or consumed within Virginia or on property stored outside Virginia for subsequent use or consumption within Virginia. Use tax applies only to transactions on which sales tax is not paid.

Two types of property are exempt from consumer's use tax. First, property brought into Virginia by a non-resident is exempt. Second, property already placed into substantial use in another state or property moved into Virginia in connection with establishment of a residence or business is also exempt, provided that the property was purchased at least six months prior to being moved into Virginia.

Corporate Income Tax. In FY 1991, corporate income tax comprised approximately six percent of the revenue collected by the department. This resulted in approximately $279 million in corporate income tax revenue. Taxes are paid to the department through annual returns and estimated payments by corporations throughout the year.

Corporate income tax is assessed based on Virginia taxable income of corporations, which is based upon federal taxable income of corporations with some specific additions and subtractions. There are several exemptions to corporate income tax. These include public service corporations, insurance companies, State and national banks, credit unions, elected small business corporations (S corporations), non-profit organizations which are exempt from federal taxation, and non-profit telephone companies which operate exclusively as local mutual associations.

Other Taxes. There are 17 other taxes which the department is directly responsible for administering. These taxes include estate, wills and administrations, recordation, cigarette, bank franchise, watercraft sales and use, aircraft sales and use, rolling stock of railroads and freight car companies, forest products, tire, litter, soft drink excise, motor vehicle fuel sales tax in certain transportation districts, corn assessment, soybean assessment, egg excise, and peanut excise. These miscellaneous taxes combined accounted for approximately eight percent of the total revenues or approximately $369.6 million in FY 1991.

Responsibilities for Taxes Administered by Other Entities

The Department of Taxation is responsible for some aspects of taxes administered by entities other than the department. These taxes are primarily administered by the State Corporation Commission (SCC) and local governments.

Taxes Administered by the SCC. The department has significant statutory responsibilities pertaining to the administration of public service corporation (PSC) taxes. These taxes include license tax, regulatory revenue tax, and road tax on motor carriers.

While these taxes are administered primarily by the SCC, the department is required to consult with local taxing districts concerning the ascertainment and equalization of such taxes in order to help ensure uniformity of appraisals and assessments. The department is also responsible for prescribing forms for use by local commissioners of revenue in levying PSC taxes. Finally, the department is responsible for notifying the clerk of the local circuit court if the commissioner of revenue fails to send to the concerned public service corporation a description of the locality's political boundaries within which it does business or owns property.

Taxes Administered by Local Governments. There are four general types of taxes that are administered by local governments: real property, tangible personal property, license taxes, and some miscellaneous taxes. Although the Department of Taxation is not responsible for direct administration of these taxes, the *Code of Virginia* does specify that the department perform certain functions with respect to three of these taxes.

In general, the department is responsible for establishing a classification system for real property, and for preparing an assessment/sales ratio study for each major class of real property in each city and county. The tax department is also required to design and furnish proper forms for use by localities in making a general reassessment of real estate. Upon request of the governing body of a locality, the department is required to provide advisory aid and assistance in making any general reassessment of real estate, mineral lands, or minerals.

The Department of Taxation is also responsible for developing forms for local assessing officers to annually publish the amount of tax-exempt property in their localities. In addition, the department is required to construct and maintain a system for collection of real property tax facts. The department is also required to certify local supervisors, assessors, and appraisers. Further, the department establishes a continuing education program for local assessors and boards of equalization.

Merchants are required to pay capital tax annually. The department furnishes commissioners of revenue blank forms for reporting the taxes.

The tax department is responsible for promulgating guidelines defining and explaining the categories of maximum license taxes. The tax commissioner has authority to issue advisory written opinions which interpret the provisions and guidelines for these taxes.

Counties, cities, and towns are authorized to levy taxes upon sale or use of cigarettes. The Department of Taxation is authorized to enter into arrangements with localities concerning the mechanism used to indicate payment of local and State cigarette taxes.

Statutory Responsibilities

The *Code of Virginia* empowers the tax commissioner and the tax department with broad authority governing the State tax system. Sections 58.1-100 *et seq* and 58.1-200 *et seq* of the *Code of Virginia* provide the department with specific authority and responsibility to reasonably enforce and administer the tax laws and collect all taxes due. The department also has the responsibility to encourage the highest level of voluntary taxpayer compliance and provide assistance to local governments in the areas of State and local taxation.

The tax commissioner is required to supervise the administration of the State's tax laws. The commissioner directs proceedings necessary to enforce the State's revenue laws and intervenes in any court case where the constitutionality of any State tax is at issue.

The tax commissioner is authorized to compromise and settle doubtful and disputed claims for taxes. He is further authorized to compromise or settle any tax liability of doubtful collectibility.

The department is required to make a complete record of the case whenever such a compromise or settlement is made. The record should include the amount of tax assessed, recommendations, reports and audits, the taxpayer's grounds for dispute, and the evidence supplied by the taxpayer related to the dispute.

The tax commissioner is supposed to exercise general supervision of local commissioners of revenue and to investigate improper assessments of State taxes in localities. However, local commissioners of revenue are elected officials and therefore are not accountable to the tax commissioner. The tax commissioner provides commissioners of revenue with information and assistance in the assessment of personal property. In addition, the commissioner is responsible for recommending measures to promote uniform assessments and cooperation among all officials connected with the State's tax system.

In addition to his departmental responsibilities, the tax commissioner has several other responsibilities within Virginia. These include serving as a member of the following boards and commissions: Compensation Board, Treasury Board, State Land Evaluation Advisory Council, Local Debt Council, and Commission on Intergovernmental Cooperation.

ORGANIZATION OF THE DEPARTMENT

The Department of Taxation was established in 1927 to carry out the responsibilities formerly administered by the State Tax Commission. Since its creation 64 years ago, the department has had only two commissioners. The first commissioner served from 1927 to 1969. The current commissioner was appointed in 1970, replacing an acting commissioner.

The department has undergone many changes since its creation. For example, the department had an annual budget of $117,090 in fiscal year 1928. During the five-year period between 1987 and 1992, the department's budget increased by more than $9 million (Table 1). The department's general fund appropriation for FY 1992 was $45.2 million. However, the department has a budget of $46.6 million for FY 1992 due to $1.4 million in carryover and salary regrade funding.

Table 1

Department of Taxation Budget Totals
FY 1987-1992

	1987	1988	1989	1990	1991	1992
Salary Expenses	$22,855,207	$25,010,787	$25,848,398	$28,400,187	$31,109,486	$32,832,405
Wage Expenses	1,900,263	1,972,350	2,111,170	2,101,847	2,159,407	2,297,407
All Non-Personal	12,400,048	11,629,308	12,013,758	11,710,619	10,919,975	11,529,534
Budgeted Total*	$35,923,415	$37,939,093	$39,898,416	$42,212,653	$44,343,868	$46,659,346
Total General Fund Appropriation**	$37,056,510	$38,702,194	$40,973,027	$44,020,631	$44,712,288	$46,659,346
Year End General Fund Expenditures	$35,856,780	$37,939,033	$39,892,531	$42,212,638	$43,162,882	$10,528,475***

*Includes general and non-general fund appropriations.

**This includes approved carry-over from the prior fiscal year.

***Expenditures as of September 30, 1991.

Source: Department of Taxation's year-to-date expenditures as reported on the June Monthly Budget Summary for fiscal years 1987-1991, and data provided by the Department of Taxation for fiscal year 1992.

Like most State agencies the department has absorbed staffing reductions during the last two years. The department has a maximum employment level of 929 for fiscal year 1992; however, as of September 1, 1991, the department had 84 of these positions vacant.

The department's organization has also changed through the years. The current structure is composed of a central office that is generally organized according to functions performed rather than types of taxes administered. The department also employs staff in eight district offices within Virginia as well as non-resident auditors located in 18 cities throughout the United States.

The current organizational chart for the Department of Taxation shows the eight offices/divisions directly reporting to the tax commissioner (Figure 3). The deputy State tax commissioner position was created in FY 1989 but, according to the tax commissioner, has never been filled due to funding constraints.

Most of the agency is administered by the assistant tax commissioner for the office of tax operations and the assistant tax commissioner for the office of information resource management. The other six functional areas are local liaison, internal audit, research, criminal investigation, tax policy, and administrative operations. The complete organization of the Department of Taxation is much more complex than this simplified chart would suggest.

A brief description of each of the eight primary offices/divisions within the Department of Taxation follows. The descriptions will present the organizational structure that each unit is designed to have when all established positions are filled. Currently the department has 84 vacant positions. Although several hundred temporary staff are employed throughout the agency during peak seasons, these temporary positions are generally not included in the office/division descriptions.

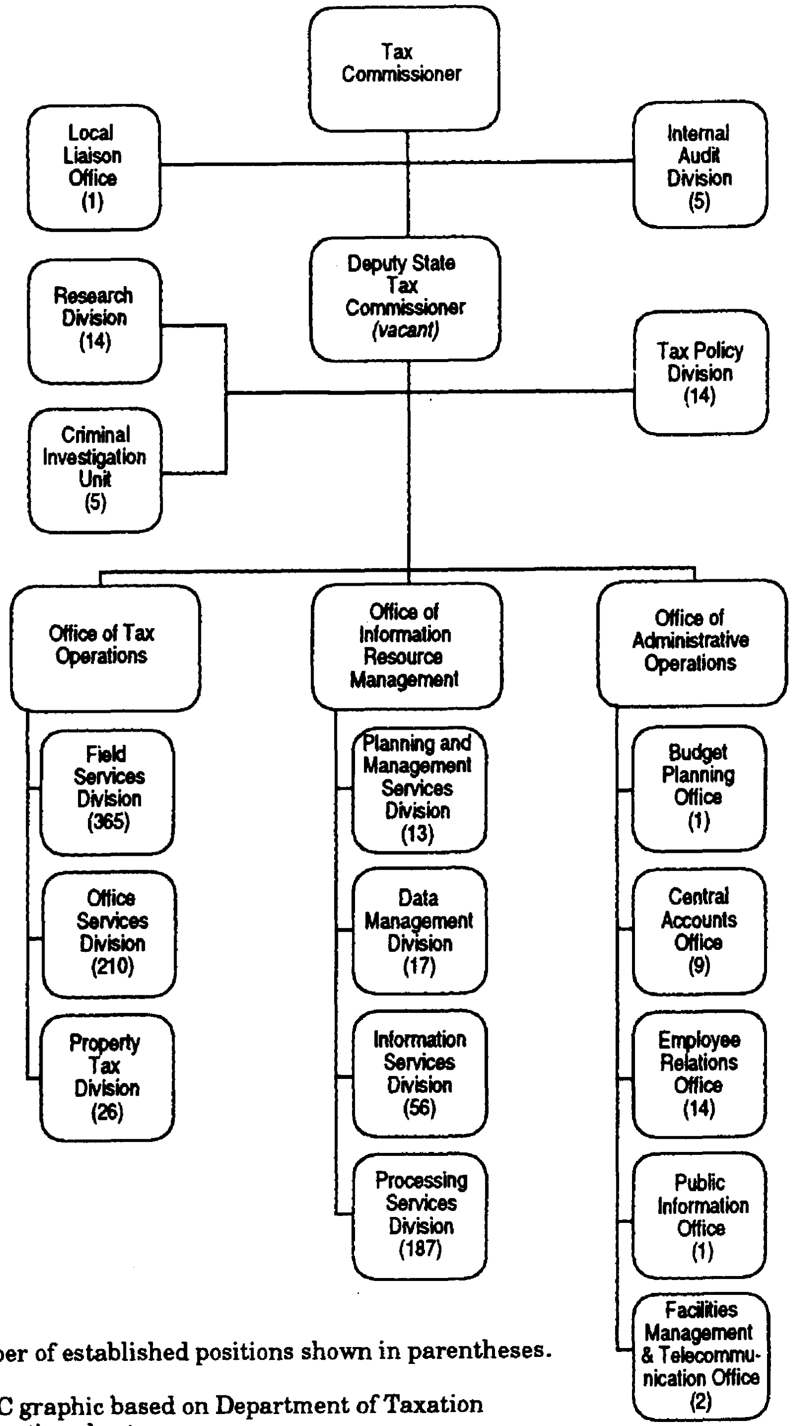
Office of Tax Operations

The office of tax operations has primary responsibility for enforcing compliance with Virginia's tax laws. In addition to these enforcement activities, this office provides taxpayer assistance and assists localities with their tax assessments. A total of 601 personnel are employed within three divisions — field services, office services, and property tax.

Field Services Division. The department's district office staff, interstate auditors working out of the central office, and non-resident auditors are placed within the field services division. A total of 314 positions are provided within the district offices to audit, investigate, and collect unreported or delinquent taxes. (The eight district offices are located in Bristol, Danville, Falls Church, Harrisonburg, Newport News, Norfolk, Richmond, and Roanoke.) Twenty-six non-resident auditors live in 18 major cities throughout the United States. These auditors examine companies that complete business transactions in Virginia. The 18 cities were chosen on the basis of where the

Figure 3

Organization of the Department of Taxation



Note: Number of established positions shown in parentheses.

Source: JLARC graphic based on Department of Taxation organization chart.

businesses with Virginia operations are located and where travel by airplane would be facilitated. The cities are Atlanta, Boston, Charlotte, Chicago, Cincinnati, Cleveland, Dallas, Los Angeles, Memphis, New York, Philadelphia, Pittsburgh, San Diego, San Francisco, St. Louis, Toledo, Trenton, and Wilmington (Delaware).

The field services division is supervised by a State tax division director. The director supervises a State tax assistant division director who oversees three sub-units — district office support, interstate audit, and district operations. A total of 365 positions are located within the field services division.

Office Services Division. Staff within the office services division perform and review tax audits, collect delinquent taxes, provide taxpayer assistance, and conduct training sessions for local financial officers. The first attempt to collect delinquent taxes is made by staff within this division. If unpaid after 38 days, delinquent business tax accounts are referred to the field services division, while delinquent individual income tax accounts are sent to the legal unit in office services for further activity. If field services staff are unable to collect on a business tax account, it is returned to the office services division for other action.

An assistant division director reports to the division director and provides direct supervision to the division's four sub-units. A total of 210 staff work within taxpayer assistance, technical services, collections, and compliance.

Property Tax Division. The property tax division provides assistance to localities in preparing assessments for real and personal property taxes. The division also drafts and revises "property identification maps" for localities. These maps are needed to allow localities to ensure that property assessments and taxes are being handled equitably. Again the division director supervises the assistant division director who provides direct supervision to three sections. These sections — property appraisal and classification, real estate mapping, and railroad and pipeline appraisal — employ 26 staff.

Office of Information Resource Management

The office of information resource management is primarily responsible for processing tax returns and accounting for the revenue generated by State taxes. Additional responsibilities of this office include monitoring agency goals and objectives and implementing all data management and information systems. A total of 273 FTEs are allocated within four divisions — planning and management services, data management, information services, and processing services.

Planning and Management Services Division. Broad goals and objectives for the agency are determined by the Department of Taxation's management team and monitored by planning and management services division staff. Division staff also provide centralized support for other agency divisions in areas such as the printing of forms, personal computer maintenance, and telecommunications activities. The division director is responsible for the 12 staff within the two sub-units — information center and management analysis.

Data Management Division. All computerized production activities, the telecommunications network, and security and quality control over computerized data are directed by data management staff. Strict security is needed to protect the highly confidential tax information contained in the database. This division is responsible for the security of the database system. The senior database administrator manages the three sub-units — database administration, operations, and quality assurance — which employ 16 staff.

Information Services Division. Staff within the information services division maintain the State Tax Accounting and Reporting System (STARS). STARS is an on-line database management system that processes tax information on individuals and businesses and can be accessed by thousands of users throughout Virginia. Some of the "external" STARS users include the Department of Alcoholic Beverage Control, the Department of Motor Vehicles, colleges and universities, local financial officers, and the court system. User access is limited to the data needed for a specific authorized purpose, such as liabilities that can be collected under the set-off debt collection program.

The division supervisor, a systems development manager, supervises the five sub-units of accounting/billing, individual return processing, business return processing, hardware/software support, and user services. A total of 56 employees work within this division.

Processing Services Division. The processing services division registers taxpayers, processes tax returns, accounts for and deposits tax payments, maintains taxpayer information, and distributes tax forms. More than 400 temporary employees may work processing tax returns during the busiest months of the year.

The processing services division is supervised by a State tax division director. The director supervises a State tax assistant division director who oversees 185 permanent staff within three sub-units — accounting, processing, and services.

Local Liaison Office

Only one position, a State tax division director, is located within this office. Technically the position is considered to be located within the office of the commissioner even though it appears as a separate entity on the organizational chart. The position is currently filled by the incumbent who retired from this position but now works on a part-time basis.

The division director is expected to be a mediator between the tax commissioner and local financial officers, board members, council members, and other local officials. Position responsibilities include assisting local officials in taxation matters as well as developing State policy that affects local taxation efforts.

Internal Audit Division

A total of four auditors and one secretary are dedicated to completing all internal audits of the Department of Taxation. Audits of financial and operational functions including data processing are conducted. Internal audit is involved on an on-going basis in maintaining the security of STARS data. Given the confidentiality of the information contained and the number of internal and external users with access to STARS, system security is critical.

Research Division

The research division is responsible for developing economic projections, revenue estimates, and fiscal impact statements for legislative alternatives. Although the department's research division has primary responsibility for the Governor's revenue estimates, these estimates are also reviewed by other entities such as the Governor's Advisory Board of Economists, the Governor's Advisory Council on Revenue Estimates, and the Governor's Economic Advisory Council.

The division is supervised by an economist chief who oversees the division's two sub-units — revenue forecasting and public finance. A total of 14 FTEs are assigned to the research division.

Criminal Investigation Unit

The criminal investigation unit was established as part of the effort to strengthen sanctions following the tax amnesty program. The unit is supervised by a criminal investigation manager, who oversees three criminal investigators and one secretary.

Tax Policy Division

The tax policy division is responsible for promulgating tax regulations and tax policy, hearing appeals of tax assessments, acting as the legislative policy liaison, and providing technical assistance to outside entities on policy matters. The division coordinates the preparation of legislative impact statements with other divisions. The tax policy division is supervised by a tax policy director. The director supervises a tax policy manager who oversees three sections which deal with sales and use, individual, and corporate taxes. A total of 14 FTEs are allocated to work within the tax policy division.

Office of Administrative Operations

The agency's financial and administrative responsibilities are carried out by staff within the office of administrative operations. This office is supervised by an assistant commissioner. In addition to the executive secretary who reports to the assistant commissioner, 27 employees work within the following sections: budget planning office, central accounts office, employee relations office, public information office, and facilities management and telecommunications office.

OVERVIEW OF THE DEPARTMENT'S COMPLIANCE COLLECTIONS PROCESS

The department is responsible for enforcing the State's tax laws by processing taxes voluntarily paid by taxpayers and collecting taxes due the State which are not voluntarily paid by taxpayers. Tax payments which are not voluntarily paid by taxpayers are referred to as compliance collections and result from specific actions by the department.

Compliance collections are conducted primarily within two divisions of the department — field services and office services. There are a total of 417 staff in these divisions involved in the audit and collections processes.

The department's collections activities generally focus on the collection of tax bills. A tax bill is issued for tax liability which is owed but has not been paid.

Staff in both divisions can work on all types of taxes. Generally, staff in the office services division collect individual income taxes and staff in both divisions collect business taxes.

The department has recently implemented some new initiatives to help increase the amount of compliance revenue collected. These initiatives are directed at promoting voluntary compliance and increasing collections.

Process for Collecting Tax Bills from Individual Taxpayers

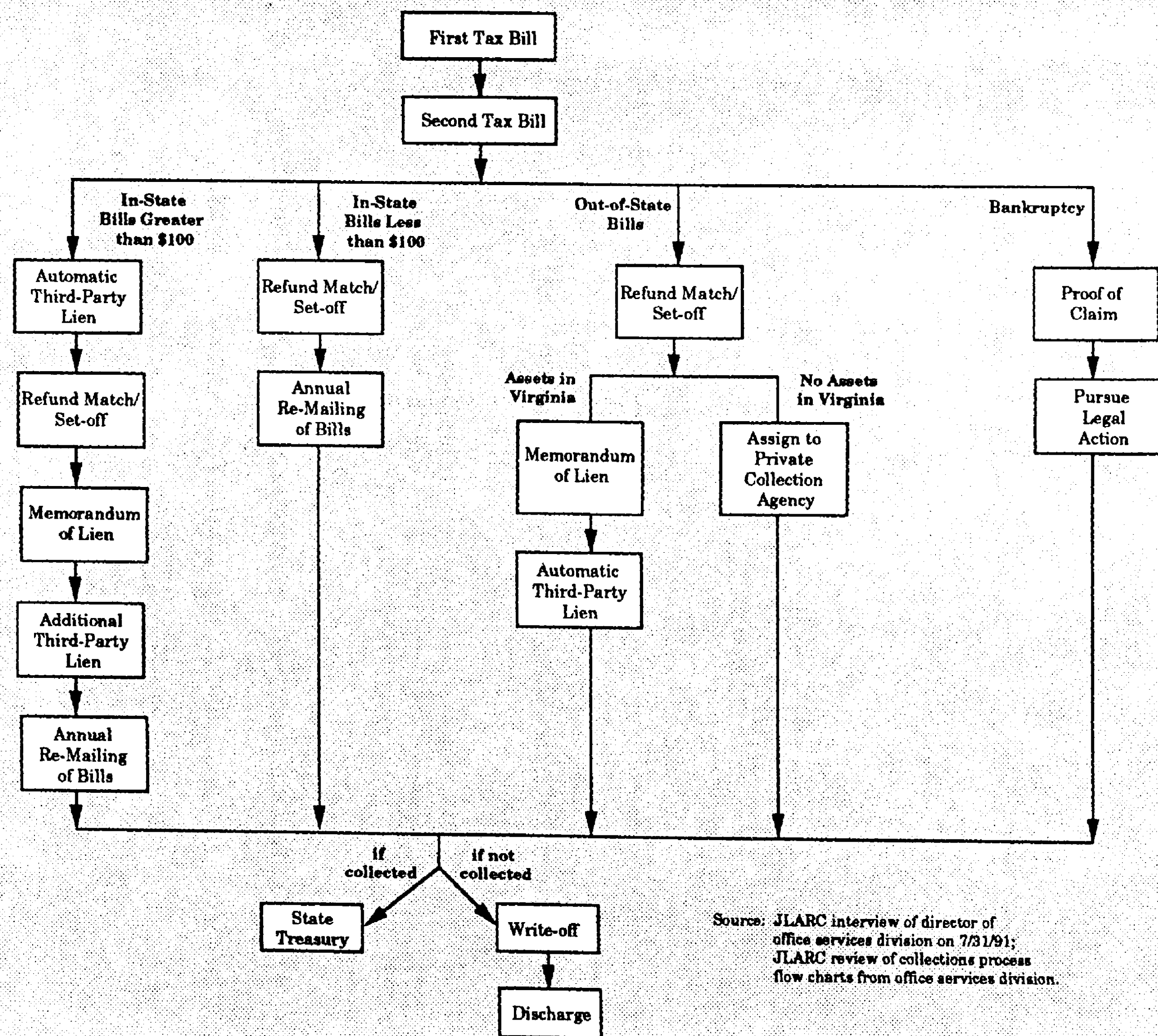
Individual income tax bills are generated in two ways:

- The staff in the compliance section of the office services division make an assessment based on an office audit which compares federal and State return data.

- The staff in the error resolution unit of the processing services division generate an assessment on an incorrect return or insufficient tax payment.

Once the bill is generated on the STARS system it is automatically mailed to the taxpayer (Figure 4). The taxpayer is allowed 40 days to respond. If no response is received, the STARS system issues a second bill and the account is assigned to the delinquent collections section. The taxpayer has ten additional days to respond. If no response is received, STARS automatically issues a third party lien.

Figure 4
General Collections Process - Individual Income Tax



Source: JLARC interview of director of office services division on 7/31/91; JLARC review of collections process flow charts from office services division.

If no response is received within 30 days of the automatic lien, the tax bill goes to the legal unit. The legal unit puts all bills into the refund set-off system and issues an automatic third party lien on all bills greater than $100. Depending on bill size and taxpayer situations, different combinations of memoranda of lien, re-mailings, and legal action can be used. For out-of-state bills which are less than $10,000, the department contracts with private collection agencies to collect from the taxpayer. Department staff collect out-of-state bills which are more than $10,000.

Eventually, the department either collects the tax bills or they are written off or discharged. A write-off suspends collections activity, although the bill remains in the accounts receivable inventory and in the refund set-off program. A discharge removes the bill from the accounts receivable inventory and from the refund set-off program.

Process for Collecting Tax Bills from Businesses

Business tax bills are generated in four ways:

- The legal unit staff in the office services division make a statutory assessment on a business which refuses to file a tax return.
- The audit staff in the field services division generate an assessment.
- The audit staff in the office services division generate an assessment.
- The error resolution unit in the processing services division generates assessments on incorrect returns.

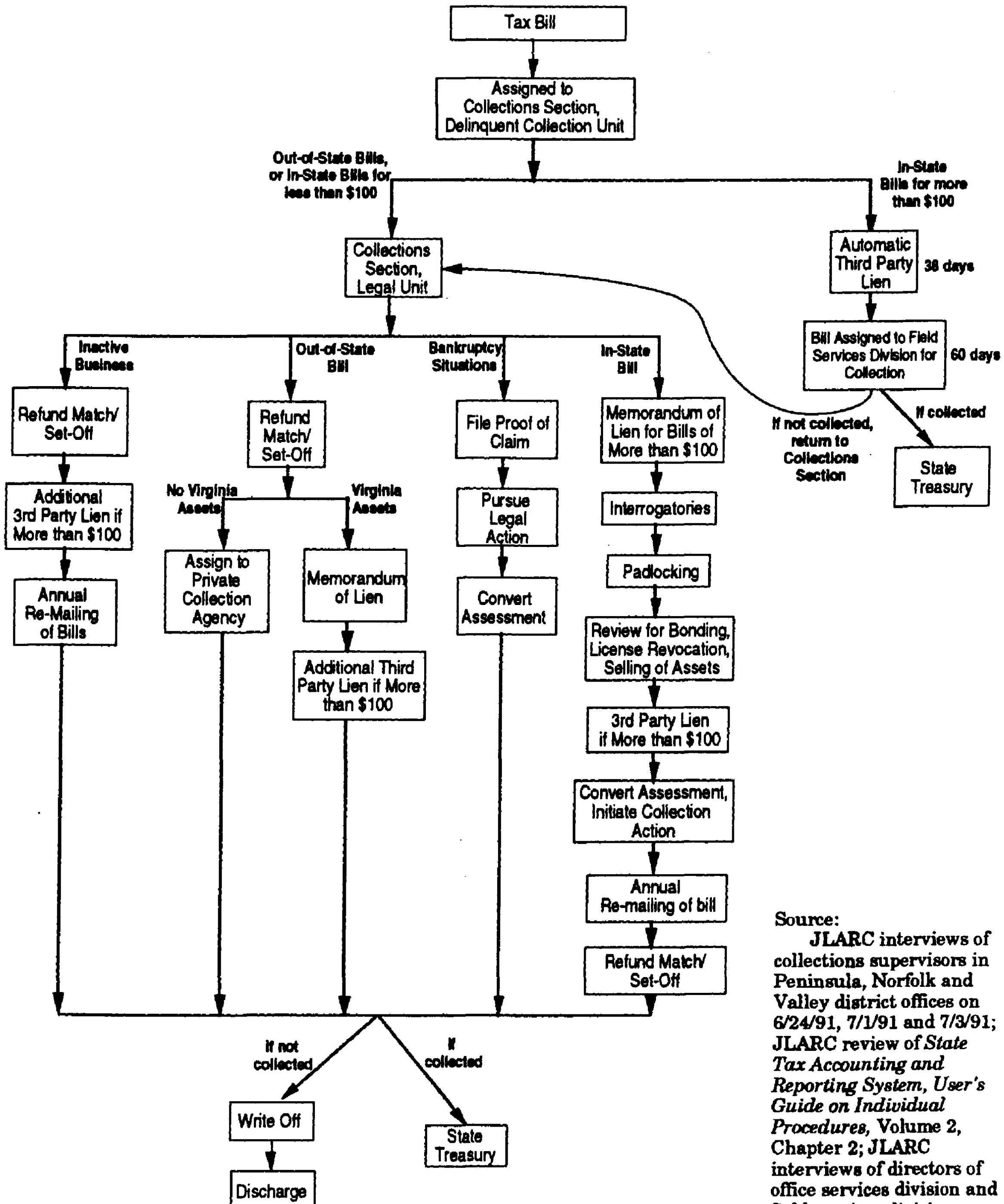
Each of these types of assessments results in a tax bill which is assigned to the delinquent collections unit in the office services division for collection (Figure 5). Staff in this unit can issue third party liens on the taxpayer's bank or other institution where the taxpayer may have assets. If the bill is not paid within 38 days and is larger than $100, it is assigned to a district office for collection.

The district office has 60 days to collect the amount due. Staff undertake a variety of activities to obtain payment including: serving the taxpayer with a notice to appear, making telephone and personal contact, and issuing a memorandum of lien or a third party lien. If a bill continues to be unpaid, the district office can initiate padlocking procedures or contact the local Commonwealth's Attorney to initiate criminal proceedings.

At the end of 60 days, unless the bill has been placed on hold, the bill is automatically transferred to the legal unit in the collections section. This unit handles bills differently according to the status of the business and whether the business is in Virginia. The legal unit staff pursue a variety of collections activities including: re-mailing the tax bill annually, putting the account in the refund or vendor set-off program, issuing a memorandum of lien, filing proof of claim, and directing sale of assets. The department eventually collects the tax bill or discharges it.

Figure 5

General Collections Process - Business Taxes



Source:
JLARC interviews of collections supervisors in Peninsula, Norfolk and Valley district offices on 6/24/91, 7/1/91 and 7/3/91; JLARC review of *State Tax Accounting and Reporting System, User's Guide on Individual Procedures,* Volume 2, Chapter 2; JLARC interviews of directors of office services division and field services division on 7/31/91. JLARC review of collections process flow charts from office services division.

Additional Collections Initiatives

As part of its collections activities, the department has implemented several programs to help increase compliance. These include the following:

- Business Padlocking — Business padlocking began following tax amnesty and involves the padlocking, seizure, and sale of establishments of delinquent business taxpayers. During fiscal year 1990, padlocking procedures were instituted against 152 businesses.

- Audits of Out-of-State Furniture Dealers and Shippers — Under this program, the department compiled a list of Virginians who purchased furniture, tax exempt, in North Carolina and had it shipped to Virginia. According to the department, it collected $222,192 in fiscal year 1991 as a result of this program.

- Border Vendor Registration — The department has implemented cooperative programs with West Virginia and Tennessee to register vendors located along the states' borders who sell items in both states. According to the department, it added 115 additional West Virginia businesses to its sales tax registration database during fiscal year 1990.

- Southeastern Association of Tax Administrators Agreement — Eleven southeastern states exchange audit information including names of businesses which sell to other states and names and addresses of customers to whom untaxed sales were made. During fiscal year 1990, the department received 49 referrals of consumer sales.

- Small Business Self-Audits — This program allows certain types of businesses to voluntarily examine their financial records and pay any additional use tax liability. Businesses which participate are laundries, dry cleaners, real estate brokers, travel agencies, and exterminators.

- Non-Resident Auditors — The department currently has 26 auditors located in 18 cities throughout the United States. According to the department, this program resulted in the collection of $13.6 million in compliance revenue during fiscal year 1991.

- Information Linkages with the U.S. Internal Revenue Service — The department receives information such as reports of federal examinations and audits of individual and corporate income, estate and gift tax returns, and the names of all federal filers with Virginia addresses.

JLARC REVIEW

Item 13 of the 1991 Appropriation Act directed JLARC to review the "organization, management, and operations of the Virginia Department of Taxation." In addition, the Secretary of Finance requested that JLARC review the department's collections activities.

Scope of the Review

Given the broad wording of the study mandate and the size and complexity of the tax department, the scope of the review was narrowed to focus on aspects of the department with greatest potential for affecting State revenue. This was seen as important given the State's current financial situation.

Therefore, this study was designed to concentrate on those components of organization and management which were identified as having a direct effect on revenue collections by the department. Other components provide services to the citizens of the Commonwealth which may improve voluntary compliance in the future. However, given the State's current fiscal condition and the concerns of the Secretary of Finance, it was determined that an examination of revenue collections would be of greatest benefit to the State at this time.

Two issues which have been addressed by JLARC previously in prior reports were not revisited in this study. First, this study does not readdress the concerns raised in the JLARC report on revenue forecasting titled *Revenue Forecasting in the Executive Branch: Process and Models*. The department's approaches to address those concerns have not yet been received by JLARC. Second, this study does not reexamine the role of the commissioners of revenue in tax collections. This role was addressed in the JLARC report titled *Funding of Constitutional Officers*.

This review occurred during a period when the department was beginning to examine possible reorganization due in large part to the retirement of 32 staff; seven of whom were either assistant commissioners or supervisors of major department sections. Given this transition of the department and the study's focus on collections activities, certain aspects of the management of the department were not covered in the review. A comprehensive staffing analysis was not conducted but was limited only to those staffing issues which directly impact collection. Therefore, certain issues of personnel and staffing were not examined including span of control, reporting relationships, classification, training, hiring, and promotion practices within the agency.

In keeping with the focus on revenue collections, there were three primary objectives for the current study:

- To compute an initial estimate of the difference in the amount of individual and corporate taxes actually owed the State and the amount of taxes reported by taxpayers. This is commonly referred to as the "reporting tax gap."

- To determine how the department maximizes the efficiency of its compliance collections activities.

- To determine if the department's organization and management practices promote efficient and effective collection of revenue due the State.

Research Activities

A number of research activities were conducted to address the study objectives. These included a staff questionnaire, in-person interviews, questions on the Commonwealth Poll administered by Virginia Commonwealth University (VCU), examination of STARS data, file reviews, telephone interviews of tax officials in other states, site visits, a special review of audit quality and documentation by the Auditor of Public Accounts (APA), and estimation of Virginia's tax gap.

Staff Questionnaire. A questionnaire was mailed to 222 department employees. Completed responses were received from 190 employees. This resulted in a response rate of 85.6 percent. The employees were randomly chosen to receive the questionnaire, which asked for opinions on communications, management structure, and availability of resources.

In-Person Interviews. In-person interviews with 30 staff were conducted during the course of the study. These interviews covered a variety of topics including job responsibilities, specific department programs, and challenges facing the department.

Statewide Survey of Households. JLARC staff contracted with the Virginia Commonwealth University Survey Research Laboratory (VCU/SRL) to collect information on taxpaying behavior. VCU/SRL included 13 questions on taxpayer behavior on the July Commonwealth Poll.

The telephone poll was conducted with a random sample of 1,218 households. From this sample 804 usable responses were obtained. Survey questions were designed to gather information on taxpaying behavior including: who filled out the respondent's State income tax return, and whether within the last five years the respondent had overstated any deductions or underreported income. JLARC used the information from the sample to project statewide estimates.

STARS Data Examinations. More than 20 STARS reports generated for use by the department were examined by JLARC staff. In addition, JLARC staff accessed STARS data to examine information on assessments and abatements made by the department.

File Reviews. File reviews were conducted in several areas of the department including tax policy, interstate audit, employee relations, and office services. During these reviews the contents of more than 500 files were examined.

Other State Telephone Interviews. Tax officials in 18 other states were contacted for information on their tax departments. The tax departments within the 11 other southeastern states were interviewed as well as seven tax departments which are recognized as being innovative and well-administered. The seven states outside the southeast that were contacted include California, Massachusetts, Minnesota, New York, Ohio, Oregon, and Wisconsin. Interview topics included oversight provided to the department, number and type of taxes administered, sizes of staff and budget for the last five years, and amount of revenue collected during the last five years.

Site Visits. Site visits were conducted at five of the eight district offices. The Northern Virginia, Norfolk, Peninsula, Roanoke, and Valley district offices were visited. During the visit, JLARC staff toured the office and conducted interviews with the district supervisor and audit and collections supervisors.

APA Review of Selected Audits. Staff from the Office of the Auditor of Public Accounts reviewed a sample of audits conducted by the department. The sample was chosen by the Department of Taxation division director for field services. The purpose of the review was to determine adequacy of audit selection and quality of audit documentation.

Estimation of Virginia's Tax Gap. The difference in the amount of taxes reported and the amount of taxes actually owed to the State was estimated. This difference is generally referred to as the "tax gap." The estimation utilized a combination of methodologies used by the federal government and other state governments conducting tax gap research.

Department Reaction to JLARC Study

The department attempted during the study to control the contact and interaction that the study team had with department employees. The department attempted to control employee input to the study through both written and oral internal communication.

As a consequence of these efforts, some employees were reluctant to talk to JLARC staff. Others who did share information with JLARC staff did so reluctantly and in some cases fearfully. As a result, some case examples in the review are lacking in detail. This was done to help protect the source of the information. (Detail has been limited in other examples to preclude identification of the taxpayer.)

Following the initial meeting of the JLARC study team and department management team members, a memorandum was distributed (Exhibit 1). This memorandum states "the Commissioner wants this review tightly controlled" and "only the divisional contacts or directors should take telephone calls or answer questions from JLARC."

Later, after the department was directed by the Secretary of Finance to permit JLARC to conduct standard one-on-one interviews with staff, a second memorandum was

Exhibit 1

FOR YOUR INFORMATION
A LOT OF COVERUP GOING ON

COMMONWEALTH of VIRGINIA

Department of Taxation
Richmond, Virginia 23282

MAR 7 1991

MEMORANDUM

TO: Management Team

DATE: March 4, 1991

SUBJECT: JLARC Review of Agency Operations

The Commissioner met with JLARC on Friday, March 1. I also attended the meeting. The review of the department's operations will begin immediately and is expected to be completed in late fall. The project manager from JLARC is ~~Charlotte Kerr~~. Ms. Kerr has performed consulting work with the Internal Revenue Service in the compliance area and has been an employee of GAO. She is currently a senior analyst on the JLARC staff. The other staff members working with her are ~~Joe Hilbert~~, ~~Joe Fraser~~, and ~~Kim Snead~~.

I have attached a list of the data that has been requested by JLARC noting the area responsible for providing this information. As indicated on the attachment, the first item is a review of STARS documentation scheduled for Wednesday, March 7. The only other date set as this point is a March 12 orientation for the team. This may include the entire Management Team; however, I am not sure at this point.

I did not have the opportunity to talk to the Commissioner a great deal about how he wants this handled. However, several items were clear.

1. The Commissioner wants this review tightly controlled. All requests will flow to the Commissioner's Office and then be filtered down through the respective Assistant Commissioners.

2. We need to establish contacts for each division at the Assistant Director or Director level. These names should be submitted to me by the end of the week. As you designate this contact, please keep in mind that it will probably be very time consuming.

3. The Commissioner indicated that only structured interviews will be conducted. Additionally, only the divisional contacts or directors should take telephone calls or answer questions from JLARC. We need to discuss this with our employees.

I will be the primary agency contact for Ms. Kerr. I hope to have more information available for you when the Commissioner returns.

If you have any questions, please call me.

[Name removed by JLARC staff]

prepared (Exhibit 2). This memorandum instructed staff "not to respond to questions that ask for your opinion or ideas on various issues." It further noted that employees were to provide "feedback" to department management following the interview. Neither memorandum was provided to JLARC staff by department management and the employees who gave them to JLARC asked for confidentiality to protect their jobs.

The second memorandum was given to employees selected for in-person interviews immediately prior to their interviews. The memorandum was also handed to employees who received the JLARC questionnaire. The questionnaire and memorandum were handed to the employees, often by a supervisor, even though the questionnaire was sent first-class mail and addressed to the individuals. Some of these supervisors stated that they were to report to the central office which of the employees had received copies of the questionnaire. Another supervisor informed JLARC staff that he had to "tell the central office everything I tell you."

Staff responded to the directives differently. For example:

One tax department supervisor informed JLARC staff that he could not answer any questions pertaining to activities performed by his section without having the questions screened by an assistant tax commissioner.

* * *

One department employee stated that he understood that as "an employee he was prohibited from talking with JLARC but that as a taxpayer he had concerns about how the department was being managed."

* * *

Another employee stated that the memo was seen as a "gag order" by employees. He stated that he was called into his supervisor's office after receiving the memo and asked if he had any questions about the memo. He was told by his supervisor that upper management had a list of employees who had received the survey.

Item 13B of the Appropriation Act directed that "all agencies shall cooperate as required and make available all records, information, and resources necessary for the completion of the work of the Commission and its staff." While the department may have complied with the "letter" of the mandate, early efforts to control the study were not consistent with the "spirit" of an open review. One of the complaints of employees during the study was that their suggestions were not given adequate consideration by department management. Because of departmental pressure that employees "not respond to questions that ask for your opinions or ideas," there are likely to be many employee opinions and ideas yet to be heard.

Exhibit 2

COMMONWEALTH of VIRGINIA

Department of Taxation

Richmond, Virginia 23282

MEMORANDUM

TO: Employees Selected for Interview by JLARC

DATE: April 17, 1991

SUBJECT: Interviews

We have been directed to allow "one-on-one" interviews with JLARC. Employees who are interviewed should be aware that our obligation is to furnish the JLARC staff with the necessary information for the performance of their duties. The key word here is information (see enclosed law). It is suggested that you not respond to questions that ask for your opinion or ideas on various issues.

Also, you may be asked questions to which you do not know the answer or are not sure of the answer. When this occurs, do not guess. You should state that you do not know the answer and that you will furnish the answer at a later date. This information should be sent to me for routing to JLARC.

Often, an experienced interviewer will use a technique known as the "interviewer pause." This is a period of silence after a question is answered. This "pause" places pressure on the interviewee to say or comment in order to break the silence. Please watch for this. Do not add to the initial request for information. Simply wait for the next question.

If possible, you should request an advance copy of all interview questions. In addition, I would like your feedback after the interview.

We are not attempting to suppress any information from JLARC. However, individual opinions or comments seldom provide an accurate picture of an issue. Again, our goal should be to provide the most accurate information possible.

Please call me if you have any questions.

[Name removed by JLARC staff]

Report Organization

This chapter has provided a brief overview of taxes administered within the Department of Taxation. Chapter II describes some of the voluntary compliance issues affecting the collection of taxes. In chapter III, some of the problems in the department's compliance collections activities are addressed. Components of the department's organization and management which affect collections are assessed in Chapter IV.

II. Voluntary Compliance Issues

The Virginia tax system, like the federal system and other state systems, is largely based on voluntary compliance. Voluntary compliance assumes that taxpayers voluntarily report and remit the correct amount of taxes due, without direct enforcement action. Under a tax system of voluntary compliance, each taxpayer pays "his or her fair share." When voluntary compliance begins to break down, some taxpayers carry more of the tax burden than they should.

The federal government has been examining the effect of decreasing voluntary compliance on federal revenue collections since the early 1970s. The U.S. Internal Revenue Service (IRS) estimates that significant amounts of revenue are lost annually due to: (1) tax filers who underreport their true tax liabilities, (2) tax filers who do not voluntarily remit all taxes due, and (3) net underpaid tax liabilities of non-filers. These three components comprise what is commonly referred to as the "tax gap" — the difference in total taxes due and taxes voluntarily paid.

It is reasonable to assume that issues which affect federal compliance levels also affect Virginia. Generally, Virginia is a conformity state. Many of the definitions used for federal individual income taxes are also used for State individual income taxes. Further, filers report State and federal tax liabilities in a comparable manner. Federal adjusted gross income is used to determine individual income tax liability for both federal and State taxes. Therefore, issues which affect reporting behavior on federal individual income taxes will most likely affect reporting behavior on State individual income taxes.

This chapter discusses the various components of reporting behavior and its effect on State tax revenues. Statewide information on taxpayer behavior was obtained from questions included on a recent Commonwealth Poll. The results of the poll are illustrated graphically on the next two pages. A glossary of tax-related terms used in this chapter is provided in Appendix C.

INDICATORS OF UNDERREPORTING

The difference in the amount of taxes actually owed and the amount voluntarily reported by filing taxpayers is commonly referred to as the reporting tax gap. The IRS estimates that nationally filers underreported their true tax liability by at least $71 billion in 1989.

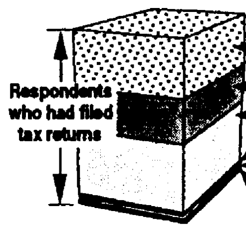
JLARC staff estimate that underreporting is also a significant problem in Virginia. For 1989, JLARC staff estimate that the gross reporting individual and corporate income tax gap for Virginia filers was at least $404 million and may have been as high as $481 million. Future development and refinement of a tax gap estimation methodology by the Department of Taxation could yield a more precise estimate.

Tax Reporting Behavior in Virginia

Based on responses to a 1991 JLARC survey of Virginia households administered by Virginia Commonwealth University's Survey Research Lab

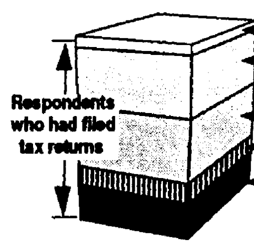
Questions | Responses | Responses Translated into Estimated Number of Virginia Households*

Who prepared your State tax forms this year?



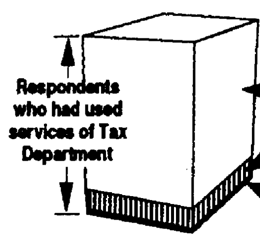
Responses	Responses Translated into Estimated Number of Virginia Households*
Self (32.3%)	620,553
Spouse, relative, or friend (23.6%)	453,407
Tax preparation firm (40.3%)	774,250
State tax assistance (1.7%)	32,661
Commissioner of Revenue (0.1%)	1,921
Other, or don't know (1.9%)	36,503
	1,919,295

How difficult would you say the State tax forms are to complete?



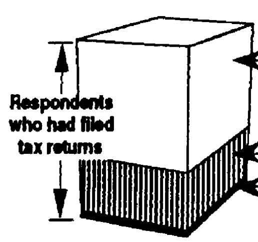
Responses	Responses Translated into Estimated Number of Virginia Households*
Very easy (5.4%)	103,607
Easy (32.1%)	615,884
Moderately difficult (32.4%)	621,640
Very difficult (10.3%)	197,620
Don't know or never used (19.9%)	381,810
	1,920,561

How satisfied were you with services provided by the State Tax Department?



Responses	Responses Translated into Estimated Number of Virginia Households*
Satisfied or very satisfied (86.1%)	222,517
Unsatisfied or very unsatisfied (11.5%)	29,721
Don't know (2.4%)	6,203
	258,441

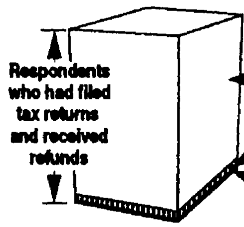
Did you receive a refund on your State taxes?

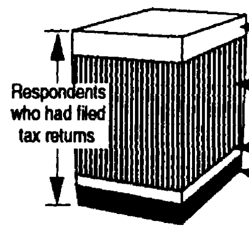


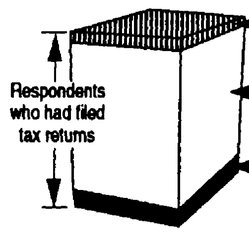
Responses	Responses Translated into Estimated Number of Virginia Households*
Yes (64.1%)	1,229,300
No (32.1%)	616,571
Don't know (3.8%)	72,990
	1,918,861

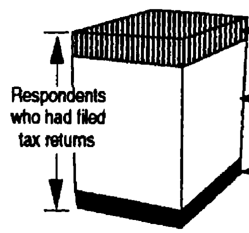
*The sum of households shown for each question varies according to the rate of response for the question and the pool of respondents being described. For example, the graphic for the third question (satisfaction with tax department services) shows opinions for only those respondents who had actually used the department's services. The U.S. Bureau of the Census estimate of the total number of Virginia households is 2,291,830.

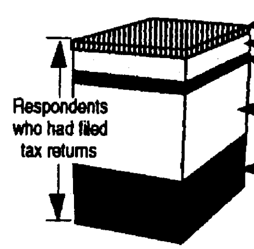
Questions	Responses	Responses Translated into Estimated Number of Virginia Households
Was your tax refund mailed to you in a timely manner?	Yes (94.3%)	1,148,474
	No (5%)	60,959
	Don't know (0.7%)	8,534
		1,217,967
Have you ever decided <u>not</u> to take an itemized deduction you thought you might be entitled?	Yes (12.8%)	245,243
	No (68.8%)	1,318,179
	Never itemized (6.4%)	122,621
	Don't know (12%)	229,915
		1,915,958
Do you think you may have overstated any deductions or expenses?	Definitely or probably have (6.4%)	122,631
	Definitely or probably have not (83%)	1,590,372
	Don't know (10.6%)	203,108
		1,916,111
Do you think you may have left some reportable income off your tax returns?	Definitely or probably have (14%)	268,380
	Definitely or probably have not (75.9%)	1,455,001
	Don't know (10.1%)	193,617
		1,916,998
Of people you personally know, how many do you think do some petty manipulating of their taxes?	More than ten (5.6%)	107,344
	Three to ten (11.5%)	220,439
	One or two (4.7%)	90,092
	None (44.6%)	854,920
	Don't know (33.6%)	644,065
		1,916,860











Notes: The survey on which this graphic is based was conducted as part of the Commonwealth Poll. For a full description of survey methodology, see Appendix E. Percentages may not sum to 100 due to rounding.

As a further indication of Virginia's tax gap, JLARC staff analyzed results from the Commonwealth Poll to estimate the number of individuals who have understated their tax liability. Approximately 17 percent of the respondents who filed returns reported that they had understated their tax liability within the last five years. Based on these responses, JLARC staff estimate that approximately 318,000 of the State's 2.3 million households have understated their tax liability.

The federal government and tax departments in other states have measured their respective tax gaps. At least nine of these states have used these measures to address compliance problems.

Federal Estimates of the Tax Gap

IRS considers that given its mission — "to collect the proper amount of tax revenue at the least cost . . . in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness" — an estimate of the tax gap is important to better develop revenue initiatives. Further, IRS states that the extent of non-compliance with tax laws and regulations conveys information necessary to design programs to meet the challenges faced in collecting taxes that are not voluntarily paid.

The U.S. General Accounting Office (GAO) evaluated IRS tax gap estimates and the approaches used to initially address the gap. GAO commended IRS for computing the estimates but cited weaknesses in the current IRS programs to close the gap. These weaknesses are important to Virginia as the tax department relies heavily on IRS data and enforcement actions in the performance of its enforcement activities.

IRS Estimates of the Federal Tax Gap. IRS began computing a federal reporting tax gap for legal sector income in 1972. Legal sector income is derived from activities which are not prohibited by statute. Since that time estimates have been produced through 1987 and projections through 1992.

IRS has refined its estimation techniques to be able to produce gross and net total federal tax gaps in addition to reporting and remittance gaps. In 1991, IRS estimated that the total gross tax gap for 1989 lay in the range between $90 to $103 billion and projected that the gross tax gap would increase to $127 billion by 1992.

IRS included three components in its computation of the total gross tax gap: (1) the amount of tax liability that taxpayers do not report on their returns, (2) the amount of tax liability that taxpayers report on their returns as due but do not voluntarily pay, and (3) an estimate of the amount owed by non-filers. IRS estimates that for 1989: (1) approximately $72 billion is underreported on federal tax returns, (2) approximately $11 billion is reported but not remitted, and (3) more than $7 billion is owed by federal non-filers — taxpayers who owe taxes but do not file returns.

IRS has also produced an estimate of the total net tax gap for 1987. This estimate is the gross income tax gap minus the amount of federal taxes paid as a direct result of IRS enforcement activity. IRS estimates that the net tax gap, for 1987, was between $60 and $72 billion. IRS has not estimated the net tax gap for any year later than 1987.

Evaluation by GAO. The U.S. General Accounting Office has evaluated both the methods of computation as well as the enforcement efforts of the IRS to close the federal tax gap. GAO found that the methodology and computation of the estimates were generally sound. However, GAO identified improvements in IRS compliance and enforcement activities necessary to close the gap.

GAO commended IRS for producing tax gap estimates. As GAO noted, reducing the federal tax gap is an important challenge given its potential harm to public confidence in the voluntary tax system and its potential importance for reducing the federal budget deficit.

However, GAO noted several deficiencies in IRS enforcement activities which adversely affect closing the federal tax gap. For example:

> *GAO identified three components of the federal tax gap which account for more than 50 percent of the 1987 tax gap estimate: sole proprietors (self-employed individuals), informal suppliers (i.e. street vendors, housekeepers, repairmen, and day care providers), and corporations. GAO found that IRS does not design its major enforcement program to pursue these types of businesses. According to GAO, IRS focuses on types of tax returns rather than types of non-compliance. Therefore, IRS enforcement programs have serious limitations in closing the tax gap.*

Weaknesses in IRS enforcement activities are especially important to Virginia, as the tax department relies heavily on IRS audits and enforcement activities. According to department staff, the majority of the individual and many of the corporate tax audits completed by Virginia's tax department are conducted because of audits initiated by IRS.

JLARC Estimate of Virginia's Reporting Tax Gap

JLARC staff computed gross and net reporting tax gap estimates for corporate and individual income taxes for 1989 and projected the 1992 gross reporting tax gap for Virginia. The gross reporting tax gap is the difference between actual State tax liability and the amount of tax liability voluntarily reported by taxpayers. The net reporting tax gap is the gross reporting tax gap minus any adjustments resulting from collections and enforcement activities.

Using the federal definitions, JLARC staff estimate that the State gross reporting tax gap for 1989 is between $404 million and $481 million (Table 2). The State net reporting tax gap is estimated to be between $325 million and $401 million. Assuming that the State gross reporting tax gap increases at the same rate as that projected for the federal gap, JLARC staff estimate that by 1992 the State gross reporting tax gap would be approximately $512 million; a portion of which is collectible.

Table 2

Federal and State Gross Tax Gap Estimates for 1989 and 1992

	Federal				Virginia			
	1989		1992		1989		1992	
Component	Estimate	Potentially Collectible	Estimate	Potentially Collectible	Estimate	Potentially Collectible	Estimate	Potentially Collectible
Reporting Gap*	$72 billion	$22 billion	$ 90 billion***	$ 27 billion	$405 million	$122 million	$512 million	$154 million
Remittance Gap	$11 billion	$ 3 billion	N/A	N/A	N/A	N/A	N/A	N/A
Non-Filer Gap	$ 7 billion	$ 2 billion	N/A	N/A	N/A	N/A	N/A	N/A
Unclaimed Over-Withholding	—	—	—	—	$140 million	**	N/A	N/A
Total	**$90 billion**	**$27 billion**	**$127 billion******	**$38 billion**	**$405 million+**	**$122 million+**	**$512 million+**	**$154 million+**

N/A Not able to compute at this time.

— Not applicable.

* Estimates in this table represent the most conservative estimates of Virginia 1989 and 1992 gross reporting tax gaps. Virginia's gross reporting tax gap ranges from $405 million to $481 million for 1989. Therefore, collectibility ranges from $122 million to $144 million. Virginia's projected 1992 gross reporting tax gap ranges from $512 million to $607 million. Therefore, collectibility for 1992 ranges from $154 million to $182 million.

** Unclaimed over-withholding amounts are not included in any totals, but are related to the tax gap. Unclaimed over-withholding may result in an understatement of the JLARC tax gap estimate since these funds have been collected by the State but may not be due the State.

***This amount was estimated by interpolating between the 1987 and 1992 federal estimates of the total gross income tax gaps. It represents underreporting by filers. It does not include the non-filer gap or the remittance gap.

****The IRS has projected that the total gross tax gap for federal income taxes will be $127 billion in 1992. The IRS has not developed estimates for the reporting, remitting or non-filer gaps.

Source: JLARC analysis of: (1) U.S. Internal Revenue Service "Compliance 2000" data; (2) methodology used in prior tax gap research by U.S. Internal Revenue Service (March 1988, April 1990), Oregon Department of Revenue (January 1987), and California Franchise Tax Board (December 1989); and (3) data in *IRS Statistics of Income Bulletin* (Summer 1991), IRS *Statistics of Income, Corporation Income Tax Returns* (December 1990), Virginia Department of Taxation STARS report TXPST13A, Virginia Department of Taxation corporate income tax liability data, and Virginia Department of Taxation data on amount of 1989 unclaimed over-withholding.

Interviews with department staff indicate that the Department of Taxation has never estimated Virginia's tax gap. Therefore, the JLARC estimate is the first attempt at measuring Virginia's tax gap. As such, it should be seen as a conservative first step in dealing with an extremely complex and technical issue. Future iterations by the tax department would be expected to be more precise and comprehensive over time.

The JLARC estimate is based on analysis of underreporting by federal filers. Generally, two ratio estimators were used: (1) the ratio of federal tax liability from Virginia returns to total federal tax liability, and (2) the ratio of State income tax liability to federal income tax liability from Virginia returns. These ratios were applied to the estimated federal gross income tax gap to derive the State estimate (Figure 6).

JLARC staff made several assumptions in deriving the estimated ranges of the State's tax gap. For the gross reporting tax gap the assumptions used were:

- Virginia's State income tax gap is proportional to its share of the federal income tax gap. Virginia's share of the federal income tax gap is a function of the ratio of federal income tax liability from Virginia returns to total federal income tax liability.
- Virginia taxpayers use their federal adjusted gross income as a starting point for their State returns. Therefore, State and federal tax liabilities are reported in a comparable manner.
- State income tax compliance patterns are not significantly different from federal patterns.

For the computation of the net tax gap the following assumptions were also made:

- Assessments are correctly abated by the department.
- Abated assessments reduce the tax gap.
- A portion of the tax gap is collected through the department's enforcement activities. However, as discussed in Chapter III, more than $43 million may be erroneously attributed to enforcement activities by the department.

Appendix D contains additional information on the methodology used to derive the estimates. The appendix includes the rationale for the assumptions as well as the supporting calculations used to derive the estimates.

Like all estimates, these estimates can be debated because of data limitations and the assumptions used to generate them. JLARC staff believe that these estimates can be refined. However, these initial estimates serve as good indicators of the difference between taxes owed and taxes reported for corporate and individual legal source income.

Figure 6

Ratios for Computing the Gross Individual and Corporate Reporting Tax Gap

$$\text{1989 Virginia Gross Income Tax Reporting Gap Estimate} = \left[\left(\frac{\text{1989 Federal Income Tax Liability from Virginia Returns}}{\text{1989 Total Federal Income Tax Liability}}\right)\left(\text{1989 Federal Gross Income Tax Reporting Gap Estimate}\right)\right]\left(\frac{\text{1989 Total Virginia State Income Tax Liability}}{\text{1989 Federal Income Tax Liability from Virginia Returns}}\right)$$

$$= \left[\left(\frac{\$14{,}125{,}112{,}000}{\$552{,}454{,}185{,}723}\right)\left(\$71{,}500{,}000{,}000\right)\right]\left(\frac{\$3{,}126{,}428{,}426}{\$14{,}125{,}112{,}000}\right)$$

$$= \$404{,}630{,}172$$

Note: **Federal income tax liability from Virginia returns** = Total 1989 Virginia individual income tax liability + federal corporate income tax collections in Virginia during FY 1990.

Total federal income tax liability = Total individual income tax liability + total corporate income tax after credits.

Federal gross income tax reporting gap estimate: the difference between the actual amount of federal income tax liability and the amount of income tax liability reported on tax returns.

Total Virginia State income tax liability = Virginia individual income tax liability + Virginia corporate income tax liability.

1989 Virginia Net Income Tax Reporting Gap Estimate = \$404,630,172 - Abatements - Compliance Revenue Collections
= \$404,630,172 - \$46,646,407 - \$32,945,036
= **\$325,038,729**

Source: JLARC analysis of: (1) methodology used in prior tax gap research by U.S. Internal Revenue Service (March 1988, April 1990), Oregon Department of Revenue (January 1987), and California Franchise Tax Board (December 1989); and (2) data in IRS *Statistics of Income Bulletin* (Summer 1991), *IRS Statistics of Income, Corporation Income Tax Returns* (December 1990), Virginia Department of Taxation STARS report TXPST13A, and Virginia Department of Taxation corporation income tax liability data.

While it is true that the total amount of this tax gap cannot be collected, research has shown that significant portions of underreported taxes due can be collected. IRS addressed collectibility of the federal tax gap as part of its Compliance 2000 strategy and stated:

> . . . even if we were given all the necessary resources we could collect no more than approximately 30 percent of that tax gap. The reason is that the gap is made of so many taxpayers in such small amounts, it is simply not cost-beneficial to attempt to collect the gap through enforcement measures.

The IRS estimate of collectibility of the tax gap may be conservative for collecting a State tax gap. States have access to databases, such as business and professional licenses and motor vehicle registrations, which are not readily available at the federal level and can be used to identify components of the gap. As such, a state should be able to collect more of its tax gap than the federal government can. However, 30 percent of Virginia's 1992 gross reporting tax gap still represents at least $154 million of potential additional State revenue. This estimate of potential revenue collections is useful for the department to use for future goal setting and to measure effectiveness of compliance programs.

Recommendation (1): **The Department of Taxation should refine the JLARC reporting tax gap estimates. The department should estimate total gross and net tax gaps for the State every two years as part of its biennial planning activities. The department should develop methodologies to include sales and use taxes and the larger miscellaneous taxes in its calculations of tax gap estimates. The department-estimated tax gaps should be used in departmental goal setting for audit, assessment, and collections activities each year. The department should report the results of its tax gap research as well as its plan for, and progress toward, closing the State's tax gap each year to the House Appropriations, House Finance, and Senate Finance committees. This information should be provided as part of the department's annual budget request.**

Other States Have Developed Tax Gap Estimates

Tax departments in at least nine of the 18 states contacted have computed estimates of their respective tax gaps (Table 3). States reported using the estimates for reasons specific to the needs of their states. However, all used the estimates for better targeting and measurement of departmental performance.

Several states have used these estimates to help target their enforcement activities. For example:

> *The Oregon Department of Revenue estimated that it had an income tax gap of $146 million in 1985. Since computing its estimate, the department has used auditors in its district offices to identify non-filers.*

Table 3

Utilization and Focus of Other State Tax Gap Estimates

State	Focus
Alabama	Used to create and measure the results of an amnesty program.
California	Determined how much the state was losing in personal income tax and justified pursuing new compliance activities to reduce non-compliance.
Florida	Emphasized lost tax revenue on stocks and bonds and enhanced collection strategies.
Massachusetts	Used by a blue-ribbon commission as part of the basis for recommendations concerning the identification of non-filers, and the assessment of collectibility of accounts receivable.
Minnesota	Estimated a sales tax gap to help measure department performance.
New York	Analyzed underreported and underremitted taxes, and established a new division to identify underreporters and non-filers.
North Carolina	Used tax gap to establish a department goal and measure performance.
Oregon	Developed a tax gap which led to programs concentrating on potentially high-yield taxpayers.
Tennessee	Developed a preliminary sales and use tax gap estimate to guide compliance activities.

Source: JLARC survey of other states, June through August 1991.

Non-filers were identified by checking property sales and business licenses. In 1987, the department reported that the project had resulted in 1,168 identified non-filers and more than $2 million in assessed tax liability.

* * *

The New York Department of Taxation and Finance has been analyzing its state compliance problems since 1984. The department determined *that non-filers constituted a significant portion of the state's tax gap. Recently, the department committed 33 staff and a little more than one percent of its total budget to its "Revenue Opportunity Division." The division's mission is to develop innovative approaches to identify non-filers and underreporters. The division is currently conducting pilot programs using computer match technologies. The division attempts to find non-filers by matching tax data with data from many of the state's larger databases including: welfare payment rolls, medical payments, child support payments, state school loans, traffic tickets, and motor vehicle registrations. During the last five years, the division collected approximately $85 million from non-filers.*

The tax departments in both Oregon and New York have been able to increase compliance collections by using creative and innovative approaches to close their respective tax gaps. Information can be obtained from these and other states which can be used by the Virginia tax department as it develops its estimate and implements programs to close the State's tax gap.

Recommendation (2): **The Department of Taxation should review the tax gap methodologies used by other states and the IRS in developing its own tax gap estimates. Further, the department should review the strategies used by other states and the IRS for improving its compliance collections efforts.**

Reporting Tax Gap Further Evidenced by Commonwealth Poll

In addition to the reporting tax gap calculated using federal estimates, JLARC staff also analyzed data collected through a recent Commonwealth Poll. These data provide additional evidence of a reporting tax gap in the State.

JLARC staff used the survey results to make statewide projections which are subject to possible sampling error. The full methodology of the collection and analysis of the data can be found in Appendix E.

Analysis of these survey data indicates that an estimated 14 percent of the State's population have understated their true tax liability in the last five years. These respondents acknowledged that they had either underreported their income or overstated their deductions within the last five years.

Of those respondents who filed returns, 14 percent acknowledged that they had underreported their income on their State taxes in the last five years. Based on the survey responses, JLARC staff estimate that income has been underreported in more than 268,000 Virginia households.

Furthermore, more than five percent of the respondents reported that they had overstated deductions on their taxes within the last five years. JLARC staff estimate that this represents approximately 124,000 households.

Virginians also appear to believe that their acquaintances are not voluntarily complying with State tax laws. Approximately 22 percent of the respondents who filed returns acknowledged that they knew at least one person who had manipulated their return; approximately nine percent of these respondents reported that they thought that at least six of their personal acquaintances had manipulated their taxes. However, approximately 45 percent of these respondents stated that they did not know anyone who had manipulated their taxes.

Based on research conducted by IRS and others, these numbers typically represent lower estimates of individuals who underpay their taxes than do estimates based on actual tax return data. Self-reported data, using telephone interviews, can somewhat underestimate illegal behavior since individuals may be reluctant to admit to committing illegal acts.

However, the data provide an independent confirmation of the existence of a reporting tax gap in Virginia. Given the percentages of respondents who acknowledge their own underreporting as well as knowledge of underreporting by others, it appears that additional efforts by the tax department to close the tax gap may serve to increase collections and promote greater public confidence in Virginia's tax system.

In addition, the results of the survey of Virginia households are comparable to results obtained from similar questions asked of other samples (Table 4). This also supports the assumption that the reporting practices of Virginians are comparable to federal reporting practices and supports the JLARC staff estimate of Virginia's reporting tax gap.

INDICATORS OF UNDERREMITTANCE

Underremittance occurs when a filer does not pay the taxes which are owed or when a business withholds taxes from an employee but does not remit them to the tax department. Underremittance is a component of the overall tax gap and further erodes the basis of tax systems, voluntary compliance.

The federal remittance gap for 1989 was approximately $11 billion. While the size of the federal remittance gap is much smaller than the reporting gap, closing a remittance gap should also be a part of a comprehensive collections strategy.

A detailed estimate of the State's remittance gap for a given year could not be completed at this time. However, there are two indicators of underremittance problems in Virginia. These indicators are the accounts receivable inventory and the results of the recently completed tax amnesty program.

While both of these data sources indicate a remittance problem, these sources cannot be used to determine the magnitude of underremittance for a given tax year. Neither of these data sources are based on specific tax years.

Table 4

Estimates of the Prevalence of Non-Compliance

Time Period	Study	Study Coverage	Prevalence Estimate (%)
Estimates for Prevalence of Underreporting Income			
Five years	JLARC and VCU (1991)	Virginia	12%
Lifetime	Yankelovich et al. (1984)	United States	16
Five years	Mason and Lowry (1981)	Oregon	17
Lifetime	Westat, Inc. (1980)	Indiana and California	12-15
Five years	Habib (1980)	Oregon	12
Estimates for Prevalence of Overstating Deductions			
Five years	JLARC and VCU (1991)	Virginia	6%
Lifetime	Yankelovich et al. (1984)	United States	7
Five years	Mason and Lowry (1981)	Oregon	6
Lifetime	Westat, Inc. (1980)	Indiana and California	6-7
Five years	Habib (1980)	Oregon	16

Source: Roth, Scholz, and Witte, eds., *Taxpayer Compliance, Volume I: An Agenda for Research (1989).*

The tax department should estimate a remittance tax gap for Virginia. The department should also further analyze the composition of the accounts receivable inventory and fully utilize the information gained from tax amnesty. The department should examine the reasons for high percentages of abatements and address any problems found. The department should use these analyses to prepare a collections strategy to begin closing the State's remittance gap.

Accounts Receivable Inventory Indicates Underremittance

The accounts receivable inventory maintained by the Department of Taxation includes taxes which have been assessed but not collected. The inventory includes tax bills for individual and most business taxes.

As of June 30, 1991, the department had a collections backlog of more than $404 million (Table 5). While there was fluctuation in the inventory during fiscal year 1991, the accounts receivable inventory averaged more than $367 million during that period. Overall, the inventory increased by $78.9 million during the fiscal year. On average, approximately $227 million of the backlog was from business taxes and $139 million was from individual income tax.

Table 5

Ending Accounts Receivable Inventory
July 1990 - June 1991

	Individual	Business	Total
July 1990 - September 1990	$127,603,520	$198,254,515	$325,858,035
October 1990 - December 1990	$135,612,101	$210,662,371	$346,274,472
January 1991 - March 1991	$144,794,735	$247,496,382	$392,291,117
April 1991 - June 1991	$151,212,763	$253,580,763	$404,793,526
AVERAGE	$139,805,780	$227,498,508	$367,304,288

Source: JLARC analysis of Department of Taxation quarterly data (STARS report TXPAR54 June 1990 - July 1991).

Analysis of the inventory indicates that the department does not collect many of its accounts receivables. As receivables age the ability of the department to collect them decreases. The department has recently improved the information which it maintains on accounts receivable. However, the information is still not sufficient to determine collectibility of the accounts.

Few Receivables Are Collected. Reports prepared by the department indicate that much of the reduction in the accounts receivable inventory is the result of tax liability being eliminated rather than collected. During each quarter of the 1991 fiscal year, the department collected less than it abated (Table 6). With the exception of one quarter, amounts abated were approximately twice the amounts which were collected. The department should analyze the reasons for the high abatement totals and take appropriate corrective action.

In April, the department began to monitor the collection of receivables by age of the receivable. JLARC staff analyzed the data for the period April through August 1991. While the department reduced its receivables inventory by approximately 11 percent, only four percent of this reduction resulted from actually collecting tax revenue (Table 7). The remaining seven percent of the accounts receivable inventory was either abated or written off by the tax department. The department abates taxes when liability is determined not to exist. The department writes off liabilities when collection is determined to be doubtful.

Further analysis showed that older accounts are less frequently collected. The department collected nearly 13 percent of the accounts which had been in the inventory for up to 30 days while only 5.3 percent of accounts which were between one and two months old were collected. Less than one percent of accounts which were more than two years old were collected.

Table 6

Collection of Accounts Receivable
July 1990 - June 1991

	July 1990 - September 1990	October 1990 - December 1990	January 1991 - March 1991	April 1991 - June 1991
Beginning Receivables	$352,671,674	$325,858,034	$346,274,472	$392,291,116
Payments/ Transfers	$ 31,676,926	$ 41,221,190	$ 35,781,043	$ 47,468,809
Abatements	$ 79,669,385	$ 52,608,946	$ 65,642,555	$ 74,428,568
Write-Offs/ Discharges	$ 6,503,315	$ 9,838,742	$ 6,669,130	$ 6,825,557
Percent of Receivables Collected	9.0%	12.7%	10.3%	12.1%
Percent of Receivables Abated	22.6%	16.1%	18.4%	19.0%
Percent of Receivables Written-Off/ Discharged	1.8%	3.0%	1.9%	1.7%

Source: JLARC analysis of Department of Taxation quarterly data (STARS Report TXPRI54 and TXPAR54, June 1990 - July 1991).

Recommendation (3): **The Department of Taxation should begin to analyze its abatement data to better determine the reasons for abatements. This analysis should be used to improve collections of assessments and to reduce the percentages of abatements of assessments.**

Collectibility of Accounts Receivable Inventory Cannot Adequately Be Determined. The department's current monitoring does not provide sufficient information to determine the collectibility of the inventory. The department determines collectibility primarily by calculating what has been collected. No systematic monitoring is conducted to determine what types of collections activities have been successful.

The department has improved its ability to track collections of accounts receivables. The Auditor of Public Accounts (APA) noted that, over time, these improvements will help the department better determine collectibility of the accounts. However,

Table 7

Collection of Total Accounts Receivable by Age of Receivable (April 1991 - August 1991)*

	Days						Years		
	1-30	31-60	61-90	91-120	121-180	181-365	1-2	More than 2	Total
Receivables	$55,857,605	$35,042,913	$29,237,225	$24,682,678	$33,434,034	$72,570,668	$71,564,783	$71,597,157	$393,987,063
Payments/ Transfers	$ 7,165,294	$ 1,857,047	$ 912,399	$ 685,499	$ 741,716	$ 1,109,916	$ 1,217,750	$ 449,565	$ 14,139,186
Abatements/ Write-Offs	$14,106,194	$ 3,891,365	$ 2,251,343	$ 1,504,583	$ 1,016,855	$ 1,994,255	$ 1,482,938	$ 1,891,248	$ 28,138,781
Percent of Receivables Collected	12.8%	5.3%	3.1%	2.8%	2.2%	1.5%	1.7%	0.6%	3.6%
Percent of Receivables Abated/ Written-Off	25.3%	11.1%	7.7%	6.1%	3.0%	2.7%	2.1%	2.6%	7.1%

*All data represent the average of individual and business accounts receivable for the period April through August, 1991.

Source: JLARC analysis of Department of Taxation data (STARS Report TXPAR84, April 1991 through August 1991).

JLARC staff analysis indicates that the department needs to make additional improve- ments which will enable the department to better assess the collectibility of the inventory based on factors such as type of taxpayer (such as size of business), financial status of the taxpayer, as well as methods of successful collections.

The accounts receivable inventory is tracked by type of tax within the two broad categories — individual and business receivables. Within these two categories, information is maintained by type of tax. However, the department does not distinguish between accounts which are collected due to payment by the taxpayer and those which are collected due to funds transferred after being posted to incorrect tax periods or account numbers. This precludes an accurate determination of actual collection of the accounts.

The accounts receivable inventory represents a compilation of data which should be monitored more closely by the department. Further, the department should begin to better analyze and evaluate the accounts and the methods of collecting the accounts.

Recommendation (4): **The Department of Taxation should begin to better analyze its accounts receivable inventory. This analysis should include a decomposition of the accounts receivable inventory using components which can affect collectibility. At a minimum, this decomposition should include an analysis of length of time that the tax has not been paid by type of tax and by financial status of the taxpayer. Further, the accounts receivable inventory should be maintained in such a manner that the data on each individual receivable can be determined without having to perform analysis of individual tax screens.**

Once this analysis has been completed, it should be used in three ways. First, the department should develop a collectibility assessment of the inventory. Second, the collectibility assessment should be used to develop guidelines and priorities for collecting the tax. Third, the department should begin to experiment with, and track the results of, randomized experiments to test methods of collections such as mail, telephone, and in-person collections techniques. The results of these experiments should then be used to develop a standard set of guidelines for collection of the accounts receivable. The department should establish an annual accounts receivable collections goal and monitor progress toward that goal.

Tax Amnesty Results Unclear

The department's tax amnesty program had two purposes. First, it allowed non-filers to file and pay taxes without penalty. Second, it allowed taxpayers who owed taxes which the department had previously identified as being owed to pay those taxes without penalty.

The department reported that, of the approximately $32 million collected during the program, more than $11 million was from existing accounts receivables. This indicates that the department was able to close a portion of the State's remittance gap. However, since the department had not estimated the size of the State's remittance gap prior to the amnesty program, JLARC staff could not estimate the amount by which the State's remittance gap was reduced.

The department has conducted limited analysis of the results of tax amnesty. The department was unable to provide information on the number of tax amnesty filers who filed returns the following year. According to the commissioner, the department is tracking this but has not written a report on the results.

Recommendation (5): **The Department of Taxation should fully analyze the results of tax amnesty to determine what information can be used to better focus collections of the remittance tax gap. At a minimum, the department should determine the number of taxpayers who filed during tax amnesty but did not file the following tax year. Using this information, the department should assess taxes for these taxpayers and then institute collections activities to obtain the revenue.**

RELATIONSHIP OF OVER-WITHHOLDING TO STATE COMPLIANCE

The State has an additional tax issue which is related to, but distinct from, compliance issues. Currently, the tax department collects a sizable amount of individual income tax revenue through over-withholding on salaried employees. Some of this withholding is not claimed on tax returns. However, since some taxpayers do not file for their tax refunds, this revenue is reported as unclaimed.

This unclaimed tax revenue results, in large part, from the State's practice of over-withholding of estimated individual income tax liabilities. Employers collect more than 100 percent of the estimated annual income tax liability for each of their employees to conform with the structure of the State's income tax withholding table. The amount of withholding required by the table is based on the lowest possible standard deduction. Therefore, taxpayers who take a higher standard deduction or who itemize their deductions have more tax withheld than they actually owe. Some of the revenue collected through income withholding is never claimed on returns; some unknown portion of this revenue is not owed the State.

For tax year 1989, the department estimates that more than $140 million of its collections was from unclaimed withholding. This unclaimed withholding represents approximately five percent of the total individual income tax collections for fiscal year 1990.

Virginia is currently scheduled to end over-withholding as of December 31, 1992. Section 58.1-462 of the *Code of Virginia* provides that the State will begin accurate withholding on January 1, 1993. Accurate withholding involves collecting only the tax liabilities that are actually owed from salaried employees.

As the State moves to accurate withholding, the amount of tax revenue collected that is not actually owed the State will decrease. Further, patterns of tax reporting and remittance by individuals may change since currently more individual filers in Virginia receive refunds than pay additional taxes. With accurate withholding, the filing of a tax return will result in more taxpayers having to pay additional taxes. Therefore, the level of individual compliance may decrease. Given the State's current financial picture, the General Assembly may wish to consider delaying the elimination of over-withholding until a more complete assessment of its potential effects can be made.

The actual behavior of Virginia taxpayers is not known. However, it seems reasonable to assume that the department needs to begin developing additional strategies for increased individual income tax collections, especially given current levels of non-compliance.

According to the tax commissioner, the department has not begun planning for accurate withholding. The commissioner indicated that with accurate withholding it will not be as easy as it now is to collect from individuals.

It does not appear than the State has adequately prepared to compensate for the revenue that may be lost with the move to accurate withholding. Given the State's current financial picture and the department's lack of planning for the conversion to accurate withholding, it may be better to postpone the elimination of over-withholding. The department needs to develop strategies for collecting tax revenue under a system of accurate withholding.

Recommendation (6): **The General Assembly may wish to consider amending §58.1-462 of the *Code of Virginia* to delay the implementation of accurate withholding.**

Recommendation (7): **The Department of Taxation should begin developing strategies for collecting taxes from individual taxpayers under a system of accurate withholding. The department should conduct research to determine reasons for non-compliance by individuals and begin to address those reasons. The department should submit a plan to the House Appropriations, House Finance, and Senate Finance committees outlining collections strategies and projected changes in revenue collections with accurate withholding.**

III. Review of Compliance Collections Activities

The Virginia Department of Taxation has stated that one of its primary objectives is to "achieve the highest possible degree of voluntary taxpayer compliance by a reasonable and balanced enforcement of Virginia's tax laws." The department encourages voluntary compliance primarily through two services provided to taxpayers: rapid processing of individual tax refund checks and taxpayer assistance.

Analysis of data from the Commonwealth Poll indicates that citizens are pleased with the services provided by the department. More than 93 percent of the respondents due tax refunds reported that they received them in a timely manner. In addition, more than 85 percent of the respondents who reported that they used the services of the department were satisfied with the services received. However, less than 11 percent of the respondents reported that they had used the services of the department. Fewer than one percent of the respondents indicated that a commissioner of revenue had filled out their tax forms.

In addition to taxpayer services, the department has recognized that effective compliance enforcement and collections activities are needed. In recent years, the department has implemented several new compliance enforcement programs which are generating compliance revenue. However, the department needs to improve three major areas of its compliance collections efforts. JLARC estimates that the improvements recommended in this chapter could have produced approximately $10 million in additional State revenue in fiscal year 1991.

First, the department needs to better establish its annual compliance revenue goal. Currently, the department's goal is understated. The goal is based not on potential collections but on prior year collections. The department should use tax gap estimates to establish future compliance revenue collections goals.

Second, the department needs to reexamine and revise its procedures for selecting taxpayers for audits. The current audit selection procedures do not appear to be sufficient to guide a balanced strategy of enforcement, collections, and deterrence.

Third, the department controls significant amounts of its compliance collections activities through its State Tax Accounting and Reporting System (STARS). The State has received recognition, both nationally and internationally, for the STARS system created by the department. This system is a technological advantage which many other states do not have. However, the system currently either has significant limitations or is being used in a manner which limits the effectiveness of the department's revenue collections activities. JLARC staff have provided examples of how this has impacted department collections activities, although the magnitude of the revenue lost due to these limitations could not be accurately estimated.

IMPROVEMENTS NEEDED IN GOAL SETTING AND USE OF STAFF

The department uses its annual goal for compliance revenue collections to help direct its compliance collections activities during the year. Although the department did not meet its compliance collections goal for FY 1991, compliance staff were frequently assigned to provide taxpayer services during that time. The department reported that it collected $941,444 less than its goal.

New Method Needed for Establishing Department Compliance Revenue Goal

Each year the department establishes an agency goal for compliance revenue collections. Compliance revenue collections are generally defined as collections resulting from enforcement activities. The commissioner reports to the Secretary of Finance periodically on the status of goal attainment.

The department set its compliance revenue goals for fiscal years 1991 and 1992 at $241.4 million and $250.2 million, respectively. The department provided JLARC with the methodology for setting the 1992 goal. As described by the department, the goal has the following components:

- the amount of revenue collections for the preceding year ($240,517,858)
- a growth factor based on the department's revenue projection ($1,443,107)
- projections based on number of personnel which reflects the recent addition of 20 auditors ($8,203,067).

Analysis of the goal setting methodology indicates that the goals are not appropriately set. The department bases its goals primarily on prior year collections, not on amounts that could potentially be collected. None of the components of underreported tax liability or unremitted tax liability appear to directly factor into the goals. Therefore, the current goal setting methodology tends to understate the amount of compliance revenue which could potentially be collected.

Recommendation (8): **The Department of Taxation should revise its methodology for setting its compliance revenue collections goals. The department should not base its collections goal on past collections but should base its collections goal on outstanding liability due the State. In order to do this, the department should analyze and refine the JLARC estimates of underreported and underremitted tax liability and determine a collectibility factor for each. The number of personnel assigned to revenue collections should continue to be a factor in the equation.**

Compliance Staff Are Routinely Used for Non-Compliance Activities

Compliance staff are defined by the department as auditors, tax examiners, field representatives, and collections representatives. Auditors and tax examiners assess additional taxes through audit assessments. Field and collections representatives collect the additional taxes which result from the assessments. These positions are funded as compliance positions.

Compliance staff are assigned to the central office and the eight district offices. The department maintains data on the activities of the 287 compliance staff in the district offices. Comparable data are not maintained on the activities of the 130 compliance staff in the central office, however. Significant portions of time are spent by compliance staff for services such as taxpayer assistance in filling out returns and helping taxpayers resolve problems resulting from department processing errors.

Using data provided by the department, JLARC staff estimate that in FY 1991 approximately $10 million was not collected by district office compliance staff due to the time spent providing taxpayer assistance such as answering questions pertaining to completion of tax forms and assisting taxpayers in correcting errors on returns. This is an extremely conservative estimate of the effect of having compliance staff conduct non-compliance activities, since it does not include central office compliance staff.

The tax commissioner authorized compliance staff to be used to provide taxpayer assistance. He stated two reasons for this decision. First, taxpayer assistance is an important function of the department. Second, no other staff were available to provide assistance.

The use of compliance staff for non-compliance activities reduces the amount of time they are able to audit and collect taxes. Overall, the department's 52 field representatives in the eight districts spent a total of 16 percent of their time on taxpayer assistance during FY 1991. Using department data on compliance revenue collected by each district office in FY 1991, JLARC staff estimate that the department did not collect $8,725,000 as a result of having field representatives provide taxpayer assistance.

Two district offices also use auditors to provide taxpayer assistance. Using the department's calculations of average assessments per hour, the department did not assess $1,735,502 in fiscal year 1991 as a result of the auditors being used to provide taxpayer assistance. Therefore, assuming that the department collects 78.7 percent of its assessments (using the JLARC estimate of collections), the department did not collect $1,365,840 by using auditors to provide taxpayer assistance.

The department could not provide an estimate of the amount of time that central office compliance staff spend responding to inquiries from taxpayers regarding processing errors. However, according to one supervisor, "it is substantial."

A recent internal department report estimates that department errors result in a major portion of the workload for compliance staff. According to the report, department errors resulted in 81 percent of the telephone calls and 45 percent of the correspondence handled by compliance staff in the delinquent collections unit during a recent two-month period. Further, many of the calls and correspondence were simple taxpayer questions due to mistakes and mishandling of returns in other areas of the department. Nevertheless, compliance staff had to respond to them and attempt to resolve the error. For example:

A taxpayer was assessed a late penalty on a return that had a due date of May 1, 1991. However, the penalty was assessed on March 22, 1991.

* * *

The amount of a taxpayer's check included with the tax return was encoded incorrectly. Consequently, an assessment was issued for the difference between the amount of the check and the amount for which the check was encoded.

* * *

A taxpayer's return was posted on March 27, 1991. However, the tax examiner keyed May 1, 1992, as the filing date. That resulted in an erroneous assessment.

Given the amount of information processed by the department, error free processing cannot be expected. However, many of the errors appeared to be simple ones that should have been initially detected by the screening unit or handled by taxpayer assistance personnel. Use of compliance staff to resolve errors involved in the processing of returns is not a cost-effective or efficient use of these staff.

In some district offices, two or three compliance staff are responsible for providing taxpayer assistance each day. A toll-free telephone number to the central office could reduce the taxpayer assistance workload of the compliance staff. Such a telephone number could direct calls to the taxpayer assistance unit in the central office, which employs 51 staff specifically dedicated to providing taxpayer assistance. During March through May of each year, the toll-free telephone number could include an option for callers wanting to check on their tax refunds. These calls could be directed to wage employees hired specifically to check on the status of tax refunds. A message listing the inquiries that could be referred to a local commissioner of revenue could also be included to reduce the number of calls that tax department staff are required to answer.

The addition of at least one taxpayer assistance position to each district office would also reduce the taxpayer assistance workload of compliance staff. The districts that currently have two or more staff assigned to taxpayer assistance because of the volume of calls and walk-in requests may need more than one position.

Recommendation (9): **The Department of Taxation should not routinely use field representatives and auditors to provide in-office taxpayer**

assistance for forms completion or to correct simple processing errors. The department should establish a toll-free telephone number for taxpayer assistance that automatically directs calls to the taxpayer assistance unit within the central office or instructs taxpayers to call their local commissioners of revenue. In conjunction with this toll-free telephone number, a taxpayer assistance position should be placed in each of the seven district offices outside of Richmond. A second taxpayer assistance position should be considered in the Norfolk, Northern Virginia, and Roanoke districts if the toll-free taxpayer assistance number does not divert enough telephone calls to allow one position to handle the demand in each of those districts.

Recommendation (10): **The Department of Taxation should improve its capability to identify and correct tax return errors, through automated error resolution, before the error results in a notice being sent to the taxpayer. If certain errors still occur, they should be handled by the taxpayer assistance unit. The department should analyze the types of errors that persist and improve error resolution to correct them.**

Some Collections Erroneously Counted as Compliance Revenue

The department monitors, on a monthly basis, the revenue that it collects from compliance activities and reports this to the Secretary of Finance. JLARC staff analysis indicates that the department erroneously reported more than $43.2 million as compliance revenue in fiscal year 1991. This inflated the productivity reported by the department for its compliance personnel.

Compliance revenue is generally defined as revenue which results from direct enforcement action by the taxing entity, not voluntary payment by the taxpayer. A review of the department's compliance revenue collections data indicates that the department is counting revenue which has not required direct enforcement action on the part of the department as compliance revenue.

The department provided JLARC staff with its definitions of compliance revenue. The following types of collections are reported as compliance revenue:

- collections of business tax assessments not including fuel tax assessments
- collections of individual income tax assessments
- collections resulting from notices sent to taxpayers before a tax bill is issued
- collections resulting from tax returns that are filed late, but before a non-filer notice is sent to the taxpayer.

Collections from returns filed late, but prior to a notice being mailed to the taxpayer, should not be counted as compliance revenue. The department does not take any direct enforcement action on these returns, but merely processes a late payment. For example:

> *A federal agency routinely mails in its monthly employer withholding tax return and payment to one of the department's district offices. These payments represent taxes withheld for the agency's employees who reside in Virginia. Occasionally, the payment is received one day late. However, the return and payment are received automatically without any direct enforcement action. The district office correctly lists the payment as late. Therefore, the funds are counted as compliance revenue.*
>
> *These withholding payments can be sizable. On one field representative's daily report a federal agency's late payment of $295,000 was 99 percent of the total compliance collections of $296,100 reported by the representative. This one late payment was also seven percent of the total compliance revenue reported for the month by the district.*

JLARC analysis of compliance revenue collections reports and definitions provided by the department indicate that, by counting revenue from late payments, the department overstated its collection of compliance revenue by approximately 18 percent for fiscal year 1991. Therefore, this inflated figure served to make the department's compliance programs appear more effective than they actually were.

Recommendation (11): **The Department of Taxation should include only those collections resulting from direct enforcement actions by the department as compliance revenue. The department should reassess its definition of compliance revenue and exclude automatic payments which have been received without a notice or other form of direct enforcement action.**

AUDIT ASSESSMENTS NEED IMPROVEMENT TO BE EFFECTIVE

It does not appear that the department has a balanced strategy of combining enforcement, collections, and deterrence in its audit selections. The department does not follow a stated formal strategy for selecting audit candidates but seems to follow an ad hoc approach that relies heavily on federal data and individual auditor judgment.

Selection could be improved by supplementing federal data with unique State data. State data have been used by other states to supplement their audit programs. Virginia has many large databases which could be used by the department to identify non-filers and help determine which taxpayers are underreporting their tax liabilities.

Further, the quality of the audits performed by the department needs to be improved. The department does not have sufficient procedures to ensure that the audits are consistent and objective.

Better Strategy and Standards Needed for Effective Audits

Tax departments usually conduct audits for two primary purposes: (1) to ensure that the audited taxpayer is assessed the correct amount of taxes due; and (2) to generally alert other taxpayers, who did not report and remit the correct amount of taxes, that an audit is possible. Achievement of these purposes requires that the overall audit strategy be balanced and that audits are of sufficient quality to withstand taxpayer challenges. While the department has an audit manual, the audit program does not have a stated and uniform strategy for audit selection. Further, audits are weakened by the lack of standard audit procedures.

General selection procedures have been developed by the department to audit returns for individual income tax, corporate income tax, and retail sales and use tax (Table 8). These procedures have deficiencies which potentially limit the revenue assessed. Individual income tax audits are limited almost exclusively to federal audits. According to a special review conducted by staff of the Auditor of Public Accounts (APA) for JLARC, the department has not sufficiently developed strategies for selecting corporate income returns or sales and use tax filings for audit. The APA's review of the these strategies found them "inconsistent and subjective."

Reliance on Federal Data Limits Effectiveness of Individual Income Tax Audits. The tax department relies almost completely on data provided by the U.S. Internal Revenue Service (IRS) for individual audit selection. IRS provides the department with information which compares aspects of State returns with aspects of federal returns for Virginia filers. Discrepancies between the returns may generate State audit candidates. IRS sends the department comparisons of income reported by taxpayers on federal returns with income identified by wage statements (W-2s) and interest and miscellaneous income statements (1099s) when the difference is more than $100. IRS also provides information from federal returns which the department uses to determine if there are differences in State and federal tax information. The IRS also provides copies of federal audits which the department uses to determine if the federal audit produced a change in the amount of taxes due the State. Total reliance on these federal data can limit the effectiveness and timeliness of State audits.

The U.S. General Accounting Office (GAO) cited weaknesses in IRS data which can limit Virginia's enforcement strategies. According to GAO, IRS failed to target major components of the federal individual income tax gap — informal suppliers, sole proprietors, and high-income non-filers. Since the department depends on federal audit data to generate its audit candidates, Virginia may not audit some groups which have potentially high levels of non-compliance.

In addition to data quality problems, federal audits are not used by the department until approximately two years after the taxpayer has incurred the tax liability. During the current fiscal year, the department is conducting audits on 1988 and 1989 tax returns. The length of time between the return filing and the audit negatively affects the collectibility of the tax liability.

Table 8

Audit Selection Criteria, Criteria Deficiencies and Suggested Improvements

Type of Tax	Curent Audit Selection Criteria	Deficiencies	Improvements Needed	Benefits
Individual	Relies on IRS data for selection	Data more than two years old High-income non-filers excluded	Supplement limitations in federal data by audits of high-income Virginia taxpayers, sole proprietors, and informal suppliers	Compensates for limitations in federal data
Corporate	State returns reviewed for possibility of additional audit assessments Federal audits reviewed	Data more than two years old No written criteria for review of returns by field auditors	Develop written uniform criteria for selection by field auditors Evaluate relative effectiveness of criteria	Enhances objectivity and consistency of audit selection
Sales and Use	All of the eight percent of the businesses that pay 83 percent of the tax are audited every three years Criteria developed differently in each district	Limited audits of small businesses Lack of uniformity in selection	Develop uniform selection criteria which include all types and sizes of businesses Evaluate relative effectiveness of developed criteria	Enhances objectivity and consistency of audit selection Provides audit coverage of small businesses Provides audit coverage for businesses with a high percentage of taxable sales

Source: JLARC staff analysis of Department of Taxation data.

Given these problems, it does not appear to be in the State's best interest to rely totally on federal individual tax audits for audit generation. The department should compensate for the limitations by supplementing the federal data with appropriate State data.

Recommendation (12): **The Department of Taxation should pilot test using selected Virginia data which can supplement limitations in federal audit data to target enforcement activities on high-income non-filers, sole proprietors, informal suppliers, and other groups known to have a high probability of**

underreporting and underremitting tax liability. The department should evaluate the pilot information to determine collectibility from these groups.

Corporate Income Tax Audits Not Guided by Standard Selection Criteria. The department conducts two reviews of corporate returns. First, the mechanics of the returns are reviewed to evaluate: (1) the consistency of State return data with federal tax information, (2) the appropriateness of supporting documentation provided by the taxpayer, and (3) the mathematical accuracy of the information. Any problems in these areas could lead to an audit.

Second, returns are reviewed by individual auditors. These reviews rely on auditor judgment and past audit history to select returns for audit. While elimination of auditor judgment would not be advantageous, a procedure which serves to structure and standardize the selection process is needed. The department should analyze the procedures currently used by auditors to determine which selection criteria produce the most effective audits. The department should use the results of this analysis to develop guidelines for corporate audit selection. These guidelines should serve to provide better focus to the corporate audit program.

Recommendation (13): **The Department of Taxation should evaluate its audit selection procedures for corporate income tax in order to identify the specific procedures which result in the most effective audits. The department should use its findings as the basis for establishing standardized and objective criteria for audit selection.**

Selection Strategy for Retail Sales and Use Tax Audits Needs To Be Developed. The department selects retail sales and use tax returns for audit using nine different sets of loosely-developed criteria. These criteria are based primarily on informal information sources such as business directories, newspapers and trade journals, and telephone directories. The lack of structured criteria result in heavy reliance on judgments of individual auditors. According to the APA,

> The Division does not have a structured method for selecting audit candidates. Field representatives and auditors use several informal information sources to identify and refer candidates for audit; however, there are no specific guidelines for selection. As a result, the audit supervisor selects businesses for audit using primarily judgment and the field representative's recommendations. Lack of standard guidelines makes the selection process inconsistent and subjective.

Some of the auditors use a more structured criterion to select audit candidates. The department has calculated that eight percent of businesses in Virginia pay 83 percent of the sales and use tax. The extent of actual use of the "8/83" criterion cannot be determined. Based on written information supplied by the department, auditors in two of the eight districts appear to use the "8/83" listing as a source of information on which audit selection criteria are based. Even in those two districts, the "8/83" is only one of many possible sources of information that can be used as a basis for audit selection.

The Roanoke district has 24 different sources of information that it uses as a basis to select businesses for audit. An auditor can use one or a combination of the information sources. The "8 / 83" listing is just one such source. Other sources include referrals from local economic development groups, referrals from local constitutional officers, and listings of out-of-State contractors.

However, the department has established a goal to audit 100 percent of the "8/83" businesses every three years. In order to achieve this goal, the department is limiting its audits of small businesses in some districts even though small businesses have been identified as a major component of the federal tax gap. The department recently directed that the Northern Virginia district office "not do small business audits unless you have collected all of the delinquent assessments and non-filer money." Therefore, small businesses in Northern Virginia will receive very few audits. This could adversely impact the general deterrence effects on small businesses in that area.

The structure of the "8/83" criterion is sound — the criterion is based on objective measures. The way in which the department is implementing the criterion should be improved so major components of the tax gap are being audited and the criterion is part of a structured and directed audit strategy. Further, the department should experiment with other selection criteria to determine if the "8/83" criterion is best for audit selection. For example, another criterion to be considered would be a ratio of taxable sales to total sales. Companies, regardless of size, would be selected for audit if the ratio exceeded an established threshold. The department should then evaluate the comparative effectiveness of these strategies.

Recommendation (14): **The Department of Taxation should establish and implement a retail sales and use tax audit selection strategy which is consistent and not subjective. The department should assess the comparative effectiveness of criteria such as the "8/83" listing, the ratio of taxable sales to total sales, and criteria used effectively by other states in developing its strategy.**

Audit Procedures Deficient. The Auditor of Public Accounts analyzed the quality of a sample of audits conducted by the department. This analysis found the department lacking in necessary audit procedures. These procedures need to be developed by the department to ensure that high quality audits are being completed. According to the APA:

> The Department does not have either standard programs or checklists to document audit procedures and set the scope of testing. But, the Division relies on the auditor's discretion to perform the audit procedures.
>
> Overall, the Department does not provide field auditors with standards to follow for audit selection . . . . The audit process neither adequately trains the auditors nor documents the supervisory review of the field auditor's work and conclusions.

The Department cannot assure the consistency and objectivity of the audit process without detailed standards. Field auditors should have standards for performing audit procedures and documenting procedures, conclusions, and supervision of work.

Recommendation (15): **The Department of Taxation should develop standards for audit procedures. These standards should be written and disseminated to all audit staff.**

Improvements Needed in Non-Filer Programs

The department attempts to identify non-filers using two primary methods. To identify individual non-filers, the department checks its records of filed State returns against IRS data. To identify business non-filers, the department checks its records of filed State returns against its records of registered businesses. The department does not use any other sources outside department records to determine business non-filers. Both methods are limited and do not identify all non-filers.

Other states are using computer matches of unique state data with tax files to determine non-filers. The department needs to develop new and more effective methods for identifying non-filers and should begin evaluating other available State databases for this purpose.

Additional Individual Non-Filers Could Be Identified Using Available State Data. The department identifies State non-filers by comparing federal data and State return data. The department can determine which federal filers did not file a Virginia return. However, if a taxpayer does not file either a federal or a State return, the department may not be able to identify the non-filer. IRS estimated in 1987 that federal non-filers owed more than $7.2 billion. One could then reasonably assume that the number of federal non-filers is substantial, that some portion reside in Virginia, and that not all have their total tax liabilities withheld.

States have access to unique databases which are not available at the federal level. Consequently, states may be able to do more than the federal government in this area. These databases could effectively be used to locate non-filers. At least four other states have successfully used state data to find non-filers and have collected substantial amounts of revenue.

Virginia has several databases which could be used to identify non-filers. Some of these data sources include motor vehicle registrations; driver's license registrations; and registration of professionals such as the State Boards of Dentistry, Medicine, and Pharmacy, and the Virginia State Bar. Data from these sources could be matched with State return data to identify non-filers.

The department has recently begun or considered some new efforts to identify individual non-filers. However, the majority of these initiatives appear to be established generally on an ad hoc, rather than a systematic basis. For example:

The supervisor of the compliance section recently began to target drivers on the NASCAR circuit for special compliance activity. He obtained the cooperation of the field services division in this effort. Field services sent inquiry letters to drivers who had been identified as having received payments for races in Virginia. The supervisor told JLARC staff that he did not have any specific evidence of a tax compliance problem among NASCAR drivers. The supervisor developed this idea based on discussions with the director and assistant director of the field services division, and the director of the office services division. The compliance supervisor said that the four of them were "sitting around talking about what we could do for initiatives."

* * *

The supervisor of the compliance section recently obtained data from the State Department of Motor Vehicles on purchases of vehicles, excluding tractor trailers and mobile homes, costing more than $30,000. The supervisor wanted to determine if the purchasers had filed income tax returns. The supervisor believed that such data might enable the department to detect those non-filers with illegal sources of income. Upon obtaining the data, the compliance section could not agree on how to assess tax liability of identified non-filers. The supervisor then met with IRS staff concerning the idea. It was decided that the department would turn the data over to IRS for use in its compliance efforts. Any audit results that IRS obtains will be shared with the department.

* * *

The supervisor of the compliance section told JLARC staff that he wants to use professional licenses as a source of data for identifying non-filers. He recently contacted the State Commerce Department concerning the availability of those data. According to the compliance supervisor, the commerce department only recently began to collect the social security numbers of licensed professionals. The supervisor told JLARC staff that the social security number would be necessary in order to identify non-filers.

* * *

The department established a program in 1990 to identify non-filers who are State employees. The tax department compares Department of Accounts wage data with State tax return data to identify non-filers. The department reports that the comparison identified approximately 3,000 State employees who did not file returns for tax years 1988 or 1989. The compliance section will begin to send inquiry letters to those individuals in early 1992.

The department needs to assess the State data available to detect non-filers. The current procedures used by the department do not systematically identify all non-filers. The department has access to databases maintained by many other State agencies (such as the Virginia Employment Commission and the State Corporation Commission) but limits its use of the data to searches for particular non-filers or to establish lien sources for particular tax accounts. The department should begin to use these data sources to systematically identify non-filers. In doing so, the department should be prepared to consider data searches which use identifiers such as names rather than social security numbers.

Recommendation (16): **The Department of Taxation should continue to use federal data to identify individual non-filers. However, the department needs to examine the feasibility and cost effectiveness of computer matches with State databases to identify and locate additional non-filers. The department should establish pilot programs to match various existing databases with State tax return records. The department should contact other states which are using computer matches to identify non-filers. Using available information, the department should develop a systematic approach to evaluate the available databases, the costs of the matching activities, and the potential for identifying non-filers with each source.**

Identification of Business Non-Filers Should Be More Systematic. The department attempts to locate non-filers by comparing two of its own databases: filed business tax returns and business tax registration. The department's procedure identifies those businesses that have voluntarily registered with the department but have not filed one or more returns. The department does not know how many non-registered businesses are currently operating within the State. If a business has failed to voluntarily comply with the department's business registration requirements, the department's program is unable to identify the business as a non-filer.

Department staff have stated that the best leads on business non-filers are those which are developed by their auditors. This is done on an ad hoc rather than a systematic basis, however. For example:

> *Department staff cite an instance when a tax department employee was flying on a commercial airline. He looked out the window and noticed the name of the company loading freight on the airplane. The employee thought that the company may not have filed a tax return. He later determined that the company was not filing so he proceeded with non-filer notification. However, the company was registered with the Virginia Employment Commission (VEC), as it had employees, and was also registered with the State Corporation Commission (SCC) to conduct business in Virginia. Data matches with these records would also have identified the company as a non-filer.*

Using this *ad hoc* approach, the department was able to detect a single non-filer. However, the number of non-filers which could have potentially been detected through systematic computer matches of tax registration data with the data maintained by the VEC and the SCC is not known.

The department does not routinely use data from the VEC or the SCC as sources of information for determining if all businesses in Virginia are properly registered. However, the department does compare return data for telecommunication companies and motor carriers with data from the SCC.

Recently the director of the field services division requested that the information systems division "research the feasibility of comparing VEC data to tax data to identify unknown employers." This request was made following JLARC's initial questions of department management regarding use of VEC data.

The department should determine the feasibility of using databases maintained by other State agencies. The department should prepare a comprehensive list of these agencies and then make a preliminary determination of which databases could potentially yield the highest number of non-filers.

Recommendation (17): **The Department of Taxation should prepare and implement strategies for systematically matching data in its business tax registration database with data from the Virginia Employment Commission, State Corporation Commission, and other appropriate State agencies. The department should establish pilot programs to match various existing databases. The department needs to develop a systematic approach to evaluate the available databases, the costs of the matching activities, and the potential for identifying non-filers with each source.**

Department Monitoring of Assessments Is Inadequate

The department does not adequately monitor its assessments. JLARC staff have identified two problems which have resulted from the department's lack of monitoring. First, the department may have overstated the percentage of collections which resulted from assessments made by its audit staff. Second, by not adequately monitoring business assessments, the department lost $1.9 million in potential collections between 1989 and 1991.

Monitoring of Assessments Needed to Help Ensure More Is Collected. The department reports the total dollar amounts of audit assessments and collections each year. However, the department does not systematically monitor collections which result from assessments for any given year. The dollars reported as collected in a given year may have been from assessments occurring in other years.

This lack of monitoring has resulted in the department having to estimate the amount of collections which result from assessments. The department may be overestimating by more than 15 percent the collections which actually result from assessments.

JLARC staff requested information from the department on the audit assessments made in 1989 and the percentage of those assessments that were collected as of June 30, 1991. The department was unable to provide the information as it could not provide nor make available the lists of any audits conducted by the office services division but stated that it would be "more than 8,000 pages." However, the department was able to provide audit information on a subset of the audits conducted by the field services division. The department estimated the amount of collections which result from assessments by analyzing a non-random sample of 130 of the audits conducted in the interstate audit unit. The department's analysis concluded that 90.76 percent of the assessments were collected.

JLARC staff analyzed a random sample of 130 of the same audit assessments. The dollar amount of the assessments ranged from approximately $13 to $336,924. This analysis indicates that 78.7 percent of the net assessments made in 1989 had been collected by June 30, 1991 (Table 9). A net assessment is the original assessment, plus any additional penalty or interest, minus any abatement.

The department's inability to relate specific assessments to the collection of those assessments and its reliance on imprecise analysis to project possible collections could result in misrepresenting the total dollars of assessments being collected. For example, in FY1991, the department made audit assessments totaling $178.1 million. The department, using its calculation, would estimate that $161.6 million would be collected. The JLARC staff analysis would result in an estimate of $140.1 million, a $21.5 million difference. Similar calculations of collections resulting from assessments have been used by the department in its budget request for additional auditors.

Table 9

Collections Resulting from Sample of 1989 Audit Assessments*

Total Liability	$1,485,714
Assessed Taxes	$1,471,027
Additional Penalty and Interest	$ 14,687
Abated Taxes	$ 90,135
Collected Taxes	$1,099,016

Percent Collected 78.7%

*Data are from a random sample of 130 audit assessments made in 1989 and reflect activity on those accounts as of June 30, 1991.

Source: JLARC analysis of STARS data.

Assessment tracking has become a concern in at least one area of the department.

> *The compliance section within the office services division recently requested that the information systems division develop a procedure to track its assessments. An assessment-tracking capability should increase efficiency within the department. Staff stated that such a report will enable them to identify specific compliance programs where assessments are generally not getting collected. Once identified, these programs could be modified or eliminated.*

Monitoring collections resulting from assessments would require that department staff: (1) track all audit assessments and (2) monitor which assessments are being collected and how much of each assessment is collected. This monitoring would allow the department to examine and evaluate the quality of the audits and the effectiveness of the collections activities.

Recommendation (18): **The Department of Taxation should track the current status of all tax assessments made by each of its various compliance programs for each year. The amount of the total assessments that have been collected, abated, or discharged should be monitored. The information should be used to evaluate the quality of audit assessments and effectiveness of collections activities.**

Failure to Convert Business Assessments. Section 58.1-1813 of the *Code of Virginia* allows the department to convert business liabilities to individual liabilities of the responsible officers of the business. The department uses this conversion authority in situations where the department has been unable to collect from the business, such as in bankruptcy situations.

The department must convert the assessment within three years of the due date of the return. Once the statutory time period expires, the business assessment can no longer be converted and collection can no longer be attempted.

According to department records, the department did not convert more than 1,400 assessments totaling more than $1.9 million during the three-year period of 1989 through 1991. According to staff there were two reasons for this loss in assessments: (1) the internal notification was not timely, and (2) staff were not available to work the cases.

Recommendation (19): **The Department of Taxation should ensure that all uncollected business tax assessments are converted to individual liabilities prior to the expiration of the three-year statute of limitations.**

ROLE OF COMPUTERIZED OPERATIONS IN COLLECTIONS

The department has developed a computerized system which it uses to perform its processing, compliance, and collections activities. The State Tax Accounting and Reporting System has brought the department forward from a manual, paper-driven process to a computer driven system with less reliance on hard copy files.

Development of STARS was a major effort for the department both in terms of staff time and cost to the State. With STARS, the department is able to process a large amount of data fairly quickly and with relative ease. Department staff commented throughout the study that STARS was a great asset to the department.

However, it also appears that there are significant limitations to the STARS system. These limitations may be due to technical deficiencies in the current system or to problems with how the system is being utilized by the department. These limitations may have resulted in the State's revenue collections efforts not being as effective as they could be. JLARC staff have identified specific instances in which problems have occurred. However, JLARC staff are unable to fully determine the amount of lost revenue that may have resulted from these limitations.

STARS Development

The department began to develop STARS in the 1970s by contracting with Arthur Young and Company to develop system requirements and a conceptual design for its processing requirements. Later, the department contracted with Ernst and Whinney to develop a tracking system to monitor compliance program productivity. The system began on-line operations in 1983. The department spent approximately $36 million to develop, implement, and operate STARS between 1981 and 1989.

The department has prepared estimates which indicate that more than $8.9 million in cost savings have resulted from STARS. These savings resulted primarily from the elimination of 94 full-time positions.

In addition to savings, the department estimates that, between 1984 and 1989, it collected more than $93 million in additional revenue as a result of STARS. These estimates include:

$87,100,000	in collections
3,200,000	from auditor productivity
1,400,000	in "other benefits"
815,000	in earned interest
200,000	in refund interest.

The department was unable to document these estimates. Therefore, JLARC staff were unable to evaluate their accuracy.

According to department staff, STARS is currently 95 percent complete. The system currently contains 21 application modules (Table 10). The department has stated that a management information reporting system (MIRS) remains to be developed. The department has prepared a budget request to develop MIRS, which according to department staff will allow the production of better management reports for compliance activities.

Limitations of the System Affect Revenue and Collections

STARS has improved the processing of information within the department. However, problems exist — either with the system or the way in which the system is being used — which limit its effective utilization for revenue collections.

Over the last several years, staff have frequently requested that many of the limitations of STARS be addressed. Most of the requests have not been addressed although many of them would improve revenue collections. The department should make these modifications a priority.

Limitations Regarding Business Taxes. The system currently has two major limitations for handling business tax accounts. The system is not able to automatically link multiple accounts for the same business and will not allow the "write-off" of business accounts.

Table 10

STARS Application Modules

Business Tax System	Individual Tax System
Registration	Tax Roll
Accounting	Accounting
Accounts Receivable/Billing	Accounts Receivable/Billing
Accounts Receivable/Non-filer	Accounts Receivable/Bankruptcy
Accounts Receivable/Partial Payment	Accounts Receivable/Partial Payment
Accounts Receivable/Collections Tracking	Accounts Receivable/Collections Tracking
Return Processing (Corporate, Withholding, and Use)	Return Processing
Audit	Refund Match/Set-off
Correspondence	Correspondence
Miscellaneous Return Processing (Vending Machine, Motor Fuel, Litter, Tire)	Audit Non-filer
Vendor Debt Set-off	

Source: Department of Taxation, State Tax Accounting and Reporting System, March 1991.

The department may have multiple tax accounts for a single business. Businesses that registered prior to 1983 were assigned a unique account number for each tax. When STARS was implemented, the department was able to consolidate account numbers for only 30 percent of the businesses. The department does not know how many businesses still have more than one account number. However, the STARS system has not been programmed to look at more than one tax account for each business prior to issuing a refund. Therefore, companies registered prior to 1983 may be due a refund on one account, have an outstanding tax bill on another account which is greater to or equal the refund due, and get the refund.

The STARS system is not currently programmed to "write off" business accounts. The write-off capability is used for individual tax accounts and allows the department to suspend collection activity on the account while keeping it in the accounts receivable inventory. The account still remains in refund set-off for possible collection.

Rather than be written off, business accounts must be discharged. When an account is discharged, it is removed from the refund set-off program as well as from the accounts receivable inventory. Discharging a large corporate account reduces a large accounts receivables inventory. However, it also reduces, by the amount of the discharge, the revenue which the State may be able to collect through refund set-off.

Recommendation (20): **The Department of Taxation should enter the necessary data and modify STARS programming to ensure that all account balances are checked for all businesses before refunds are issued. This programming should ensure that no refund is issued unless all accounts have been paid in full.**

Recommendation (21): **The Department of Taxation should modify STARS programming to provide for a "write-off" capability for business taxes.**

<u>*District Offices Not Able to Deposit Collections Directly.*</u> The eight district offices collect a large amount of tax payments and compliance revenue. However, it appears that limitations in the use of STARS necessitate the district offices having to send the payments to Richmond for deposit. JLARC staff estimate that the inability of district offices to make direct deposits may have cost the State approximately $123,000 in lost interest in fiscal year 1991.

JLARC staff analyzed a sample of checks received by the district offices to determine the length of time from receipt to deposit. Twenty-five checks received in the district offices between April and June were tracked through to deposit in the general fund. On average it took six days from the time of receipt to deposit. Some checks were deposited as quickly as three days after receipt, while others took as long as 11 days. JLARC staff calculated that approximately $9,000 was lost in interest payments from the sample of checks which totaled $9.9 million.

The department reported that $93,063,711 was collected in the eight district offices during fiscal year 1991. JLARC staff used the sample data to determine the number of days from receipt to deposit. Using information on daily interest rates provided by the Department of Taxation, JLARC staff estimate that the State lost at least $61,498 and may have lost as much as $225,495 in fiscal year 1991. The department should make the changes necessary to permit district offices to make direct deposits.

Recommendation (22): **The Department of Taxation should modify its procedures to enable district office staff to make local deposits of State tax payments into the general fund. The department should request assistance from the Office of the Auditor of Public Accounts to ensure that necessary safeguards are followed in setting up and depositing into the accounts.**

Staff Have Requested that Limitations Be Corrected. The department has a process which employees use to submit requests for modifications to STARS. Many of the limitations which JLARC staff identified during the course of this review had been identified by department staff and had been submitted to the information systems division for correction. Many of these requests would result in modifications to STARS which would improve the efficiency and effectiveness of the collections process. According to the director of the information systems division, the requests have not been implemented either because they have not been made a priority by department management, they would be too costly, or sufficient staff resources are not available in the division to implement the modifications.

Some of the requested modifications need to be implemented. These include:

- Add write-off and reinstatement capabilities to the business system such as the ones that already exist in the individual system.
- Add active businesses to automatic conversions.
- Immediately assign accounts with jeopardy assessments to the district offices for collection.
- Change the way an account is automatically cycled through the collections process.

Department staff have also requested that a program be written which will enable the reading of federal business tapes which the department has been buying for the past ten years. The department has not written the programs to be able to read the tapes. According to staff, these tapes are purchased from the IRS for approximately $900 per year. The tapes may contain data which the department already receives in hard copy form from the IRS. However, additional data may be on the tapes which could assist the department in better collecting compliance revenue. The department should either use the data or cease purchasing the data tapes.

Many of these staff recommendations could result in additional revenue for the State. The department should carefully consider staff recommendations and make appropriate changes.

Recommendation (23): **The Department of Taxation should ensure that the information systems division consider and implement appropriately those employee suggestions which have a direct and cost-effective impact on the amount of compliance revenue the department can collect. Further, the department should not continue to purchase data tapes which it does not have the capacity to read. The department should either develop the capacity to read the tapes or discontinue their purchase.**

Assessment of STARS Needed

The issues which the department needs to address to better collect compliance revenue include determining a plan and method for conducting computer matches with large databases, determining which databases should be used, and determining if reports which necessitate using a large amount of data can be generated relatively easily and stored fairly inexpensively. STARS is an Information Management System (IMS) application. Some of the problems with STARS could be due in part to the limitations of IMS. IMS is a hierarchical database product which allows large amounts of data to be processed efficiently. However, IMS does not provide for easy report generation, so many information requests would require substantial amounts of programming.

The department is currently beginning to explore the possibility of using a relational database (DB2) in conjunction with its IMS system. No formal plan has been developed by the agency for this. However, staff have indicated that DB2 will probably be used for all new programming initiatives. The potential impact of using DB2 could be greater flexibility, reduced programming requirements, and improved reporting capabilities.

Before implementing any new initiatives for the STARS system, the department needs to fully determine its needs and uses for the system. This assessment should include addressing both technical and management problems with the system.

Recommendation (24): **The Secretary of Finance or Department of Taxation should request that the Department of Information Technology conduct a systems analysis of STARS to address the current deficiencies in the system and to determine long range requirements. At a minimum, the following issues should be examined:**

- **Does STARS effectively serve all units within the Department of Taxation?**
- **To what extent and by what means does STARS need to interface with outside entities?**
- **How can management be supplied with reliable and accurate information?**

- **Is system security adequate?**

- **Can application programs be developed, maintained, and enhanced quickly and economically?**

- **How can data be processed in an efficient and timely manner?**

- **How can data integrity be ensured?**

- **How can flexibility be maintained?**

- **What types of procedures need to be developed or modified to ensure that employee suggestions which affect collection of revenue are identified, given high priority, and implemented?**

IV. Organization and Management of the Department of Taxation

The Department of Taxation is a large and complex agency with many diverse responsibilities. While this review focused primarily on the department's responsibility for revenue collections, aspects of the department's overall organization and management were also examined. The review identified concerns within three areas of department operations that need to be addressed.

First, the department is generally organized according to the functions performed by staff. While this functional orientation appears to be sound, certain organizational aspects of the department appear to limit the department's effectiveness.

Second, effective management of a department which is as large and complex as the Department of Taxation requires a detailed and well-formulated planning process. The department's management team meets for two days each year to discuss and prepare biennial budgets and to consider changes that will impact tax administration. The department has recently developed and revised a written strategic plan for the agency. The revised plan recognizes the importance of external factors such as an aging population and internal factors such as technology, staffing, and facility needs for department operations. However, this plan lacks a comprehensive approach to integrating these factors. Further, the plan does not appear to adequately address the effects of externalities on department operations.

Third, the department is granted broad authority by the *Code of Virginia* to administer the Commonwealth's tax laws. Statutory requirements for accountability and external oversight of department activities are limited, despite the fact that decisions affecting billions of dollars in tax revenue are involved. Problems identified during this review, coupled with limited statutory guidelines, indicate the need for enhanced accountability and oversight.

ORGANIZATIONAL ISSUES WITHIN THE DEPARTMENT

The Department of Taxation is generally organized according to functional responsibility. Three assistant commissioners — for administrative operations, tax operations, and information resource management — oversee 12 offices and divisions. Five additional units, offices, or divisions are supervised by the tax commissioner.

While organizing on the basis of function appears to be more efficient than organizing on the basis of the type of tax being administered, realignments could be made that would help to address management problems within the agency. The JLARC staff review revealed three primary organizational needs: (1) to fill the deputy commissioner position, (2) to reorient the structure of the department, and (3) to address workload and management disparities.

Deputy Commissioner Position Should Be Filled

The Department of Taxation is a large, complex agency. Collecting billions of dollars of tax revenue, processing a variety of taxes, and forecasting revenue collections are just a few of the agency's primary responsibilities. In spite of the department's size and the magnitude and complexity of its operation, there is no official second in command. This situation is exacerbated by the necessity for the tax commissioner to serve on committees which require time away from the department. According to department documentation, the commissioner's ancillary duties within Virginia include serving on the Compensation Board, the Treasury Board, the State Land Evaluation Advisory Council, the Local Debt Council, and the Commission on Intergovernmental Cooperation.

A deputy commissioner position was created in FY 1989 but has never been filled. The commissioner has indicated that he would like to fill this position but has been unable to because of the budgetary problems the State has recently faced. In the interim, the assistant commissioner for information resource management seems to have been informally recognized as the second in command.

As noted previously, there are two additional assistant commissioners who are at the same level and pay grade within the organization. This informal arrangement could cause confusion within the organization. A related problem is that, other than the commissioner himself, there is no one individual that outside entities can contact to obtain information about the department as a whole. Currently, entities must contact individual sections within the department. A deputy commissioner could provide such a focus for information and integration of department activities.

The commissioner stated he did not consider it crucial to fill the deputy commissioner position. He noted that any of the assistant commissioners were familiar enough with the operation of all of the divisions to make any necessary decisions. This did not seem to be the case, however. The assistant commissioner, who is informally recognized as being second in command, was unable to answer questions about significant department operations, noting that they were not within his office. A mid-level manager also emphasized the need for a deputy commissioner stating, "There ought to be someone in charge, someone who could act and do it in his [the commissioner's] absence."

If cost is the primary impediment to filling the deputy commissioner position, filling the position could be linked to abolishing or vacating one assistant commissioner position. The reorganization proposal developed by JLARC staff and presented in the following section includes a structure with one deputy commissioner and two assistant commissioner positions. Such an approach could significantly reduce the cost to the department of filling the position.

Recommendation (25): **The Department of Taxation should fill the deputy commissioner position. The deputy commissioner should be responsible for understanding all aspects of the department's operation and be capable of administering the department in the commissioner's absence.**

Structure of the Department Should Be Reoriented

The tax commissioner has indicated that he plans to institute a comprehensive restructuring of the department. The impetus for the restructuring is reported to be the loss of staff due to early retirement and budget reductions. The JLARC review found that a reorientation of the department's current structure could provide cost-efficiencies, improve management, and ensure organizational continuity. Two significant problems noted with the department's structure included having a number of small administrative units and dividing portions of both audit and collections responsibilities between two divisions.

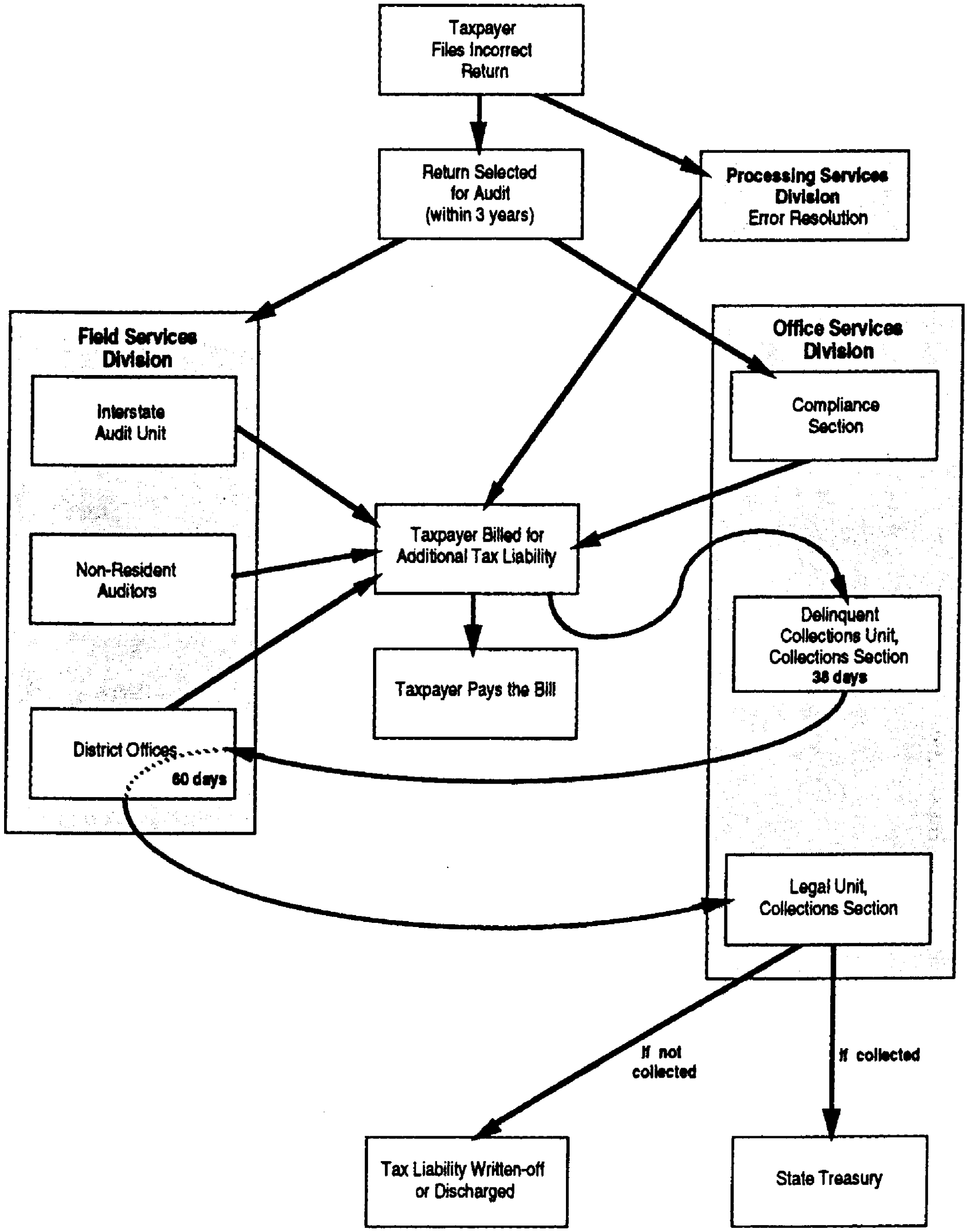
Proliferation of Small Administrative Units. The department's current organization includes a number of small administrative units, some with only one staff member. A number of problems may result when units with limited staffing exist. First, it is difficult to accommodate variations in workload. When the workload is heavy, the one person responsible for completing the work may become overwhelmed. Conversely, when the workload is light, that person may not have enough to do. Creating larger units from several small units allows for cross-training and a leveling of workload. The tax department has a number of units which have very few staff, including the local liaison office with one part-time employee, the budget planning office with one employee, the public information office with one employee, and the facilities management and telecommunications office with two (permanent) employees.

Fragmentation of Audit and Collections Activities. Responsibility for the audit and collections functions are shared by two divisions — office services and field services. This has resulted in competitive rather than cooperative operations and the diffusion of responsibility for audit and collections activities.

There are several courses that an incorrect tax return may follow once it is received by the Department of Taxation (Figure 7). Some incorrect returns may not be identified unless they are selected to be audited. If selected to be audited, the return will be sent to the field services' interstate audit unit, non-resident auditor program, or a district office. It could also be sent to office services' compliance section. If the audit determines that an additional tax liability is owed, the taxpayer will be billed for the additional amount. A different process is initially followed for tax returns identified as being incorrect. These returns are sent to the error resolution section within the processing services division. If the review by error resolution shows that an additional tax liability is owed, the taxpayer will be billed for the additional amount. Regardless of whether the bill resulted from an audit or error resolution finding, unless the bill is paid promptly, it will be assigned to the delinquent collections unit within the offices services division. At this point the collections process begins.

Figure 7

Overview of General Collections Process for Assessments



Source: JLARC interviews of collections supervisors in Peninsula, Norfolk and Valley district offices on 6/24/91, 71/91 and 7/3/91; JLARC review of *State Tax Accounting and Reporting System, User's Guide on Individual Procedures*, Volume 2, Chapter 2; JLARC interviews of directors of office services division and field services division on 7/31/91. JLARC review of collection process flow charts from office services division.

As noted, the first step in the collections process allows the delinquent collections unit within the office services division to collect the liability. Staff within the delinquent collections unit have 38 days to resolve the account or put the account on "hold." Otherwise the State Tax Accounting and Reporting System (STARS) will automatically send the account to a district office within the field services division (unless it is an individual income account, which is not typically sent to a district office). The district office has 60 days to resolve the account or put it on hold, or STARS will send the account back to the office services division, this time to the legal unit. Ultimately the tax liability is either collected or discharged in some manner.

The dividing of collections activities between two divisions has resulted in competitive, non-productive attitudes and inefficient practices.

> *A collections supervisor within a district office noted that the office services division "skims the cream off the top" by only handling the "easy" collections accounts. The supervisor contended that the accounts that are more difficult to resolve are sent to the districts.*

* * *

> *A district supervisor stated that the department "was losing money because of the way office services had sat on the cases for months before sending them to the field." The supervisor noted that grocery stores can incur delinquencies of $100,000 in sales tax quickly. By the time the district receives the case, the stores may be four to six months behind in their taxes. The supervisor surmised office services either "has too many accounts to work or they do not prioritize them properly."*

* * *

> *Two survey respondents noted problems between divisions. One respondent in a district office wrote that he would like to see the divisions, "work together as a team to accomplish our objectives — eliminate squabbles between division/office so they can take credit for doing something — creating impressive statistics seems to be very important to management; however, it does not reflect what is actually being done." Another respondent from the office services division wrote, "remove the us-versus-them mentality that exists between various divisions."*

While field services staff assert that office services needs to send cases more quickly, a report of the collections process that was completed by office services staff charged that field services was receiving too many cases. This report, submitted to office services division management in June 1991, concluded that accounts which could be collected by office services were being sent to district offices which could not handle the number of accounts being sent. Having office services handle more of these accounts was found to result in quicker collection of funds, thereby resulting in less money being written off or discharged. The report recommended:

> . . . that the responsibility and control of Collections be placed under one umbrella. The committee realizes a Collections Division has previously been recommended and turned down. History has also shown that only minimum improvement is achieved when individual supervisors from internal collections and FSD [field services division] are charged to work together. The reason for this is lack of authority to properly deal with the big issues.

As noted in the previous chapter, JLARC staff found significant problems with the collections process. Organizing on the basis of function (audit or collections activities) rather than location (central or field offices) would be consistent with the overall organization of the agency. It may also help to strengthen both functions by enabling one manager to be responsible for establishing consistent policies and procedures, for reviewing the effectiveness of the entire function, and for setting priorities for the function. Organizing on the basis of function (Figure 8) would also end the transferring of delinquent accounts between the office services and field services divisions, which should facilitate the collection of tax revenue.

Alternative Organization Should Be Considered

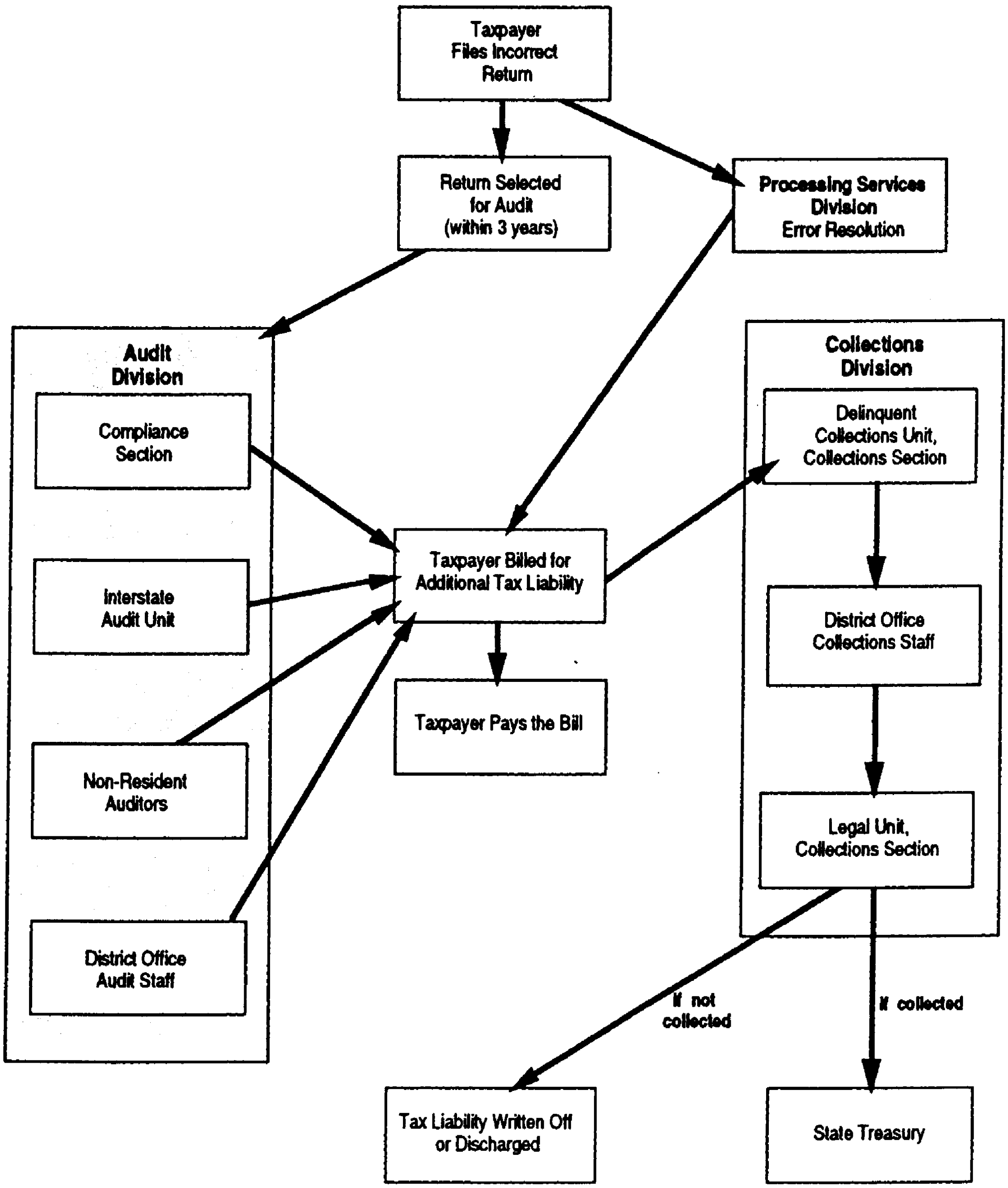
A proposal for organizing the department to address current structural and management problems was developed by JLARC staff (Figure 9). The proposed structure combines a number of small administrative units with other units and places responsibility for audit and collections activities in separate divisions as noted in the previous report sections. Whenever possible, the structure also reassigns diverse tasks currently handled by a single unit to other units that handle related tasks and consolidates tasks that are currently handled by several different units. These proposed actions are consistent with the themes of consolidating functions and offices, simplifying work processes, and improving "productivity through the use of more efficient and effective procedures" — themes which are part of the Governor's proposal for streamlining State government. A description of the "new" divisions proposed under the deputy commissioner and the two assistant commissioners follows.

Units Under the Tax Commissioner. Under the proposed department organization, the tax commissioner would directly supervise the deputy commissioner, an executive assistant for local affairs, the criminal investigation supervisor, and the internal audit supervisor. The two assistant commissioners would report to the commissioner through the deputy commissioner, a reporting relationship consistent with the department's own proposal for establishing a deputy commissioner. This would reduce the commissioner's span of control and reinforce the independence of the work of the criminal investigators and internal auditors.

Support Units Under the Deputy Commissioner. The proposed organization places all support units, other than the units which support the computer hardware and software, under the deputy commissioner. The organization of the research and employee relations divisions would not be changed. The tax policy division would remain unchanged except for incorporating the public information officer.

Figure 8

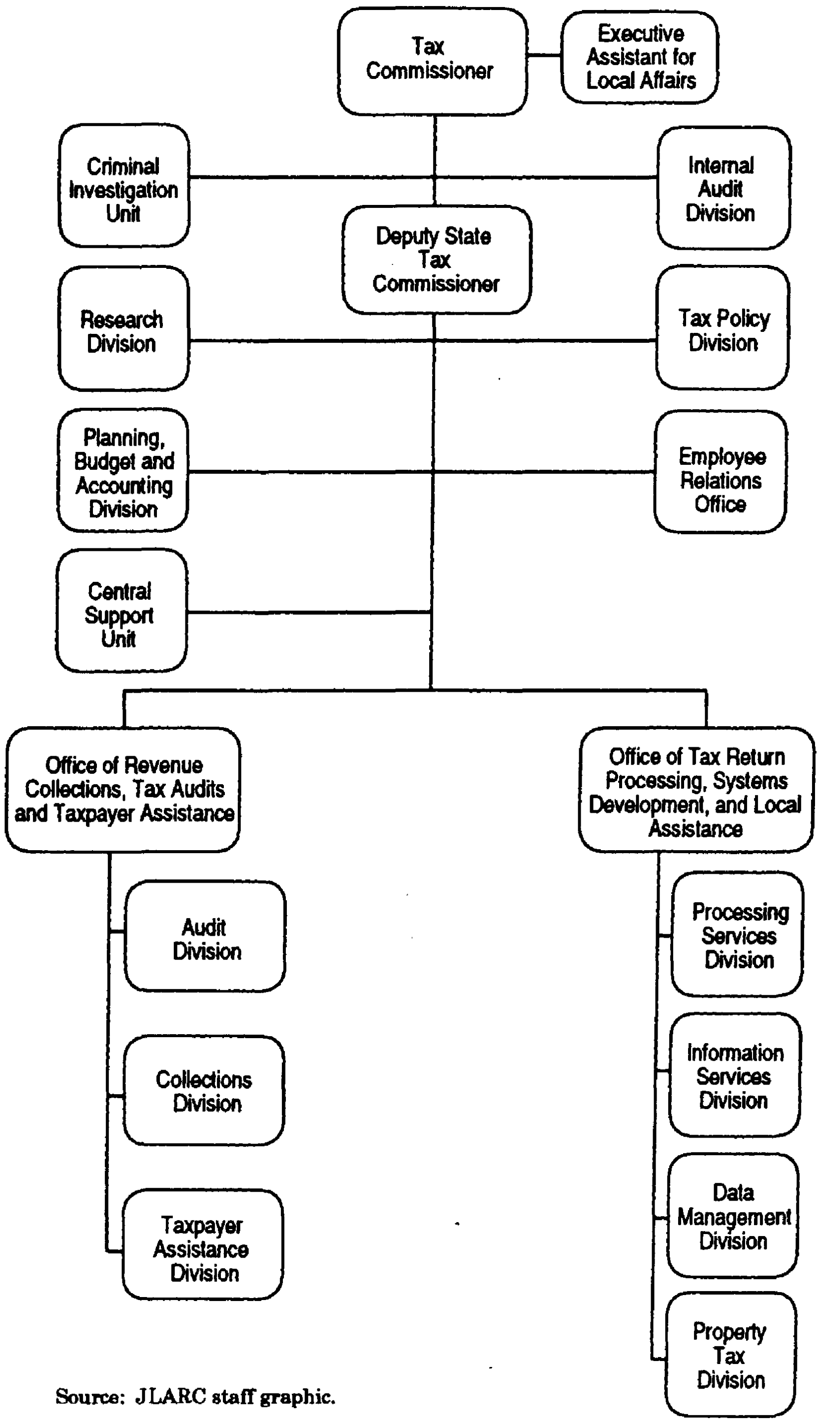
Overview of "Reorganized" Collections Process for Assessments



Source: JLARC staff graphic.

Figure 9

An Alternative Organization for the Department of Taxation



Source: JLARC staff graphic.

The planning, budget, and accounting division would place the person responsible for the budget in the unit responsible for accounting and processing of expenditures. Planning staff, responsible for tracking agency objectives and assisting in strategic planning, would also be added and could work closely with staff familiar with the agency's budget and expenditures.

The central support unit would encompass facilities management; the mailroom; and procurement, purchases, and inventory. These are all centralized services that benefit the entire agency. Designating the deputy commissioner as the agency's contract administrator would also consolidate procurement activities within one office.

Office of Revenue Collections, Tax Audits, and Taxpayer Assistance. The field services and office services divisions would be reconfigured into an office consisting of three divisions — audit, collections, and taxpayer assistance. As noted previously, this would provide for a functional organization of audit and collections activities allowing one division director to oversee all aspects of the assigned function. This configuration would also eliminate having responsibility for collecting delinquent accounts divided between two divisions.

Audit, collections, and taxpayer assistance units would be moved according to the function they currently perform. Currently some staff supervise audit, collections, and taxpayer assistance functions. These staff would be reassigned to one of the three new divisions with the exception of district supervisors. District supervisors would continue to supervise both audit and collections functions (through the audit and collections supervisors) within their own districts and would report to both audit and collections division directors. Although this reporting relationship is not ideal, it is preferable to having two divisions share responsibility for portions of the audit and collections functions. Taxpayer assistance would include the current taxpayer assistance units in the central office and at least ten additional positions that should be distributed among the district offices and would report directly to a supervisor in the central office.

Office of Tax Return Processing, Systems Development, and Local Assistance. The information services and the data management divisions would assume responsibility for the software and hardware required for the department's personal computers. These two divisions currently have responsibility for applications and terminals that relate exclusively to the mainframe. As noted previously, the mailroom and purchases and inventory would be moved out of processing services and would be placed within a central support unit under the deputy commissioner. Responsibility for the printing of tax forms would be assumed by the central support unit also. The property tax division would remain unchanged.

Recommendation (26): **The Department of Taxation should reorganize its operations to accommodate the filling of the deputy commissioner position, to reduce the number of assistant commissioners to two, and to address current organizational weaknesses. The reorganization should also reassign the audit and collections functions to ensure that two different divisions no longer have responsibility for both collecting delinquent accounts and auditing taxpayers.**

Staff Could Be Better Utilized

The Department of Taxation could better utilize its staff by adjusting workload and staff placement, by making equipment and physical plant improvements, and by relating additional staffing needs to potential revenue collections. The problems noted by JLARC staff involved not only the efficient use of department staff, but directly affected the tax revenue collected by the department.

Amount and Challenge of the Workload Assigned. A questionnaire, sent to a random sample of 222 department staff during the spring of 1991, asked employees a series of questions regarding the work they performed. The respondents generally reported that they had a clear understanding of their jobs, that the quality and amount of work expected was reasonable, that their work was interesting, that they did not have too many responsibilities, and that staffing within their sections was appropriate. However, in the following areas, more than 35 percent of respondents indicated problems:

- 36 percent reported that they were required to request approval for decisions they should be allowed to make
- 65 percent stated they could handle more responsibility than they currently had.

More than 70 percent of the respondents in grade levels ten and above reported that they could handle more responsibility. This finding was supported by interviews with supervisory staff in the agency.

Several district supervisors noted that their ideas for improving the operation of their offices were seldom approved by central office management. One supervisor related that he had "little to manage other than keeping the district office operations straight because the majority of the significant decisions that affect the district office are made in central office."

* * *

The district supervisors generally noted that they were not consulted about the unusual assignment of a large number of delinquent individual income tax accounts before the accounts were sent. Several supervisors stated they would have protested the assignments if they had been given the opportunity.

* * *

One supervisor told JLARC staff that recent changes in work responsibilities had left her with so little to do, she now "spends 20 hours on State work and 20 hours on personal work" each week.

While some staff reported being able to take on additional responsibilities, others had been assigned more work than they could complete.

> *A review of one of the units within the office services collections section revealed that account assignments are based on the type and characteristics of the accounts. These assignments seem to be made without regard to the number of accounts the employee already has. A review of the accounts on hand on July 26, 1991, showed that they ranged from 247 accounts with an estimated value of $644,815 to 25,969 accounts with an estimated value of $1,763,792. While the employee with more than 25,000 accounts is assigned accounts with balances of less than $100, this workload appears unmanageable.*

An unmanageable workload may help to explain the transfer of more than 17,000 delinquent individual income accounts with tax assessments of approximately $22.9 million from the collections section within the office services division to the district offices within field services. Two collections supervisors reported receiving accounts dating back to the 1960s. The department was unable to supply information concerning the tax years of the accounts. When asked why these delinquent accounts had accumulated, department management stated that office services staff had gotten behind because of a backlog created by tax amnesty. As of August 1991, approximately 4,000 of these accounts had been resolved and approximately $4.4 million in taxes had been collected by the district offices.

When asked about the assignment of these cases to the district offices, department management indicated the district offices have always had responsibility for collecting delinquent individual income tax accounts. JLARC staff learned, however, that very few individual income tax accounts had been assigned to the district offices during the last six years. In fact, individual income tax cases were not tracked on the utilization report for district collections staff, until this transfer was made, because so few cases had been assigned. Several district supervisors surmised that the JLARC study was the reason for this change in practice.

District supervisors generally indicated that they did not receive advance notice that individual income tax accounts would be sent to them. This sudden and unexplained transfer of accounts to the districts caused a number of problems, however. The cases had to be worked in addition to the business accounts already assigned, burdening the collections staff. Several district supervisors also noted that their staff had to be given access to and trained on the individual income tax screens on STARS because it had been so long since they handled these accounts.

The transfer of these individual income tax accounts to the district offices does not appear to be the most efficient way to address the backlog. First, the STARS system has been designed to facilitate the handling of these cases by the office services division in the central office. Second, the primary advantages that the district offices have in collecting accounts — padlocking and the revoking of business licenses — relate to delinquent business accounts rather than individual accounts.

The substantial workload differences within the tax department should be addressed. Having some staff who are not challenged or busy while others have more than they can handle is clearly an ineffective use of staff.

Recommendation (27): **The Department of Taxation should review all currently established positions to ensure that work responsibilities are commensurate with the employees' abilities and time constraints.**

Recommendation (28): **The Department of Taxation should limit the number of delinquent individual income tax accounts that are sent to the district offices. If individual income tax accounts accumulate, they should be handled by the central office and additional delinquent business accounts should be sent to the district offices.**

Placement of Staff. There appears to be no persuasive rationale for where staff are placed, particularly within district offices. For example, 60 additional auditor positions have been authorized for the department for the 1992 biennium. Field services management placed the audit positions in six of the eight districts.

> *Three of the auditors were assigned to a district whose supervisor had not requested additional audit positions and whose dollar values for audit assessments on a per-hour basis was the second lowest of all eight districts for FY 1991. When asked about the low assessment totals, one supervisor within the district noted that the number of businesses audited had increased, which resulted in the downgrading of the potential of some audits. When asked why additional auditors were received when the quality of the audits being performed was already questionable, the supervisor noted that "audits seem to run in cycles and we hope ours will improve."*
>
> * * *
>
> *In a second district office, 12 additional audit positions had been authorized and hired during FY 1991. This office did not have desks for these additional auditors, so special working arrangements had to be made to allow some staff to work out of their homes. One arrangement provided staff with computer access to STARS data so they could work at their homes. A second arrangement allowed staff to work within the office on odd or even days. If an office-based computer was needed, on a day that one of these staff was scheduled to be out, he or she had to call into the office to determine whether a desk would be available.*
>
> *This district's problems were further exacerbated in FY 1992 when ten additional positions were assigned. The district supervisor stated that during the time the additional positions were being assigned, he had repeatedly advised central office management that without additional*

office space and support personnel, he did not want any additional auditors.

As noted, one district which had low per-hour assessment totals received three additional auditors while another district which had no additional space received 22 additional positions. Management decisions regarding where to place the additional audit positions did not maximize assessment potential or consider the availability of office space and support staff.

Recommendation (29): **The Department of Taxation should involve the district offices in its decision making regarding the assignment of audit and collections staff. The availability of office space and support staff and the revenue potential of the district offices should be considered when assigning audit and collections staff.**

Provision of Equipment and Office Space. The JLARC staff questionnaire of department staff asked about the availability of equipment and computer terminals for staff use. Questionnaire respondents noted problems with the availability of both. Department-wide responses indicated that more than 20 percent of respondents did not think that enough equipment, including computer terminals, was available. The needs seemed to be greater in field services, where approximately 40 percent of respondents noted deficiencies. This perception, on the part of field services staff, was confirmed during site visits to district offices.

JLARC staff site visits to five of the eight district offices indicated that while the conditions found in the offices vary, some offices appeared overcrowded, with an inadequate number of telephones and computer terminals. The availability of desks and telephones and the adequacy of square footage within each district office varies (Table 11). Telephones are shared by office-based staff, with as many as five staff sharing a single telephone. Some district supervisors also noted that computer terminals and word processing equipment are inadequate. Telephones and computer terminals are critical to audit and collections staff in completing their job responsibilities. Having an insufficient number of telephones and computer terminals could negatively affect the productivity of district office staff.

Complaints about the furniture and the need to constantly repair it were also made. Most of the offices were furnished with the furniture they had when the offices were originally opened. Often the furniture that had been added through the years was furniture that other agency divisions had declared as surplus.

Square footage allowances were also generally inadequate within the district offices. The Department of General Services (DGS) suggests 120 square feet of space as a guideline for maximum space needs for staff within grades 9 and 10 (as field representatives and field representative seniors are). In an open office environment, the maximum guideline for staff of grade 8 and below is 64 square feet. Only three of the district offices had at least 64 square feet per office space. These three district offices also use staff office space for storage or general use. District supervisors noted they were

Table 11

Office Space Information for Districts as of September 3, 1991

Region	Number of Office-Based Staff	Number of of Desks	Number of Telephones	Square Footage	Square Feet Per Desk
Bristol	6	6	2	498*	83
Danville	7	7	4	568*	81
Norfolk	41	42	19	1,762*	42
Northern Virginia	52	53	16	2,700	51
Peninsula	12	13	7	488*	38
Richmond	48	39	16	1,173**	30
Roanoke	14***	14	9	864*	62
Valley	4	13	3	1,047*	81

* Includes space used for other purposes such as storage or general use.
** Includes only space available to the staff.
*** Includes criminal investigator position located in the Roanoke district office.

Source: Department of Taxation district office staff.

concerned about the effect that inadequate space, furnishings, and support had on staff productivity. As one supervisor noted:

> There aren't enough phones to do the job. There aren't enough support staff. Audit and collections staff are doing their own data entry. They can't focus on their primary function.

Home-based staff also have unmet equipment needs. The department's Internal Auditor, in a 1989 report on the operation of one district office, noted that locked file cabinets should be provided for use within the homes of all home-based staff to ensure protection of confidential taxpayer information. Only one district has received file cabinets for use within the homes of a number of its home-based staff. Home-based staff also frequently provide their own desks, chairs, and answering machines.

Recommendation (30): **As part of the Department of Taxation's strategic planning process, the conditions of the district offices and the effect of those conditions on productivity should be examined. As part of this examination, the amount of floor space and the condition and availability of furniture and equipment should be reviewed. The department should determine whether it would be more cost-effective to emphasize an office- or home-based approach within each district office in determining space, furniture, and equipment needs. Included within furniture needs should be a locking file cabinet for each home-based collections and audit employee. A furniture and equipment replacement schedule should also be developed for each district office.**

Need for Staffing Reviews. During the JLARC review of the Department of Taxation, a number of inefficient practices were noted. Some of these practices may have resulted from the department's inability to adequately staff certain activities. In many instances, deficient staffing actually impacted revenue collections.

Although this study did not include a comprehensive review of staffing needs or personnel practices, there was evidence that the number of compliance positions allocated to the department may have been inadequate. District office supervisors indicated that they needed additional field representatives to maintain currently required collections activities. One collections supervisor noted that although additional audit positions had been hired, they were not accompanied by additional positions dedicated to collecting the assessed revenue. Three of the five district supervisors interviewed indicated that they could effectively increase tax revenue collections if additional field representatives were hired. This disparity in the number of collections staff both in the central and district offices will increase if the additional compliance activities recommended in Chapters II and III are implemented.

The need for additional support staff was also noted. Although the department has maintained an 89 percent fill rate for all compliance positions, freezing other types of positions which provided support to collections staff negatively impacted the productivity of collections staff.

> *Several district supervisors noted that because of clerical staff vacancies, audit and collections staff were regularly required to answer the telephone and greet taxpayers. As one supervisor noted, when you consider that the field representative may collect on average $250 an hour and make $29,000 a year in salary, the cost of misusing such personnel is astronomical.*

Requiring compliance staff to complete administrative and clerical work and taxpayer assistance activities (noted in Chapter III) reduced the time compliance staff had to make assessments and collect revenue. Thus, the need for additional taxpayer assistance positions has been established and is recommended in Chapter III.

Additional staffing may also be needed to address problems in the areas of planning and information services. As discussed later in this chapter, enhancing the strategic planning process may require that additional resources be dedicated to the planning function. Similarly, making the changes in STARS programming that were recommended in Chapter III may require additional staffing within the information services division, at least initially. The increased revenue that changes to STARS could provide should more than offset the additional staffing costs. These changes include providing for computer matches with other databases, converting business tax assessments, allowing local deposits of tax payments, and providing a "write-off" capability for business taxes.

The tax department should submit a preliminary staffing plan that relates operational changes with the need for additional staff and the expected revenue or savings impact of these changes. Support and other non-compliance staff that are needed should be included in the plan to ensure that compliance staff time can be maximally used in assessing and collecting tax revenue.

A comprehensive evaluation of tax department staffing needs and personnel practices is also needed. Considering the importance of appropriately staffing the tax department to allow for the efficient and effective collection of tax revenue, the Secretary of Finance should require the Department of Planning and Budget to complete this evaluation as soon as possible. Findings made in this report that may impact department staffing needs should be considered when the staffing evaluation is being completed.

Recommendation (31): **The Department of Taxation should submit a preliminary staffing plan that links the implementation of additional compliance activities with the staff needed to carry out those activities. An estimate of any expected revenue increases or cost reductions should be included within the plan also. This staffing plan should be submitted for consideration prior to the 1993 General Assembly Session.**

Recommendation (32): **The Secretary of Finance should require the Department of Planning and Budget to complete a comprehensive evaluation of staffing needs and personnel practices within the Department of Taxation. In completing the evaluation, a close examination should be made of revenue-producing improvements; the proposed reorganization; variances in workload; the number of management staff; and the Department of Taxation's personnel practices including hiring and promotion practices, job classification, affirmative action, and salary and benefits administration. This evaluation should be completed prior to the 1993 General Assembly Session.**

Number of Management Positions Should Be Reduced

Structural changes which involve reducing the number of management positions and layers of management within the department could improve agency functioning. Reducing layers of management is also a central theme of the Governor's proposal for streamlining State government. Although an extensive review of the number of management positions and the resulting span of control was not attempted, evidence that the number of management positions could be reduced was noted.

The average number of subordinates per manager ranges from one to 23, and the layers of management within the divisions are as high as six (Table 12). Adding the management layers of assistant commissioner and commissioner results in a maximum of eight management layers for the entire department. Approximately 14 percent of the department's 949 established positions have supervisory responsibility.

Reviewing the span of control within tax department divisions revealed that six directors had a span of control of one non-clerical position. In some of these divisions, the director actually supervised some of the subordinates who were shown as being under the assistant director's supervision. One suggestion, submitted to department management from agency personnel in October 1990, recommended eliminating assistant director positions to "maximize efficiency, streamline operations and minimize confusion."

Table 12

Utilization of Management Positions

Organizational Unit	Number of Management Positions	Number of Non-Management Positions	Average Number of Subordinates Per Manager*	Number of Subordinates (Range)	Maximum Layers of Management
Local Liaison	0	1	**	**	0
Budget Planning	0	1	**	**	0
Public Information	0	1	**	**	0
Facilities Management	1	1	1	**	1
Criminal Investigation	1	4	4	**	1
Internal Audit	1	4	4	**	1
Planning and Management	3	10	3.33	3-5	2
Research	3	11	3.67	3-5	2
Central Accounts	4	5	1.25	1-4	3
Employee Relations	4	10	2.5	2-5	2
Data Management	4	13	3.25	2-6	3
Tax Policy	5	10	2	2-3	3
Property Tax	6	20	3.33	1-13	4
Information Services	14	42	3	1-11	3
Office Services	20	190	9.5	2-20	4
Processing Services***	22	165	7.5	1-23	6
Field Services	38	327	9.39	2-23	4
TOTAL****	130	819	6.3	1-23	8

*Excludes filled hourly positions and contract labor.
**Less than two management positions; consequently, no range given.
***Positions primarily supervising wage employees counted as non-management positions.
****Includes the tax commissioner, three assistant commissioners, and four support positions.

Source: Department of Taxation's personnel report of 9/91, organizational charts, and interviews with department managers.

Questionnaire responses from department staff also indicated that employees felt the department had too many management positions. Of respondents expressing an opinion, 59 percent indicated that there were too many layers of management, and 60 percent indicated that there were too many management staff. Eighty percent of the supervisors expressing an opinion indicated that they could supervise more staff, while only five percent noted they had too many staff reporting directly to them.

Recommendation (33): **As a function of its reorganization, the Department of Taxation should review the position description for each management position to ensure that the position and the management responsibilities are needed. The goal of this examination should be to reduce the number of layers of management and actual management positions over time.**

MANAGEMENT PROBLEMS WITHIN THE DEPARTMENT

Effective management of an agency as large and complex as the Department of Taxation requires a proactive planning process; a committed, well-utilized work force; and a responsive management team. In reviewing the department, JLARC staff talked with a number of employees, both managers and subordinate staff, who were committed to doing the best jobs they could. Many of these staff were quite helpful, pointing out recent improvements in agency operations as well as persistent problems. Actions that the department needs to take to address these problems include enhancing the strategic planning process, instituting additional safeguards related to employee integrity, and addressing deficiencies noted by other agencies and tax department staff.

Strategic Planning Needs Improvement

Strategic planning is particularly critical for an agency which needs to integrate sophisticated technology, staffing, and management procedures in order to respond to an ever-changing external environment. The Department of Taxation has a formal planning process and developed its first written strategic planning document during FY 1991. However, the JLARC staff review found two areas in the department's strategic planning process that should be addressed. Addressing these areas should enhance strategic planning and result in more useful planning documents.

First, long-range planning activities are limited in their scope and do not appear to consider the effect of changes in one area on other areas. Therefore, better ways to integrate and fully utilize technology, staffing, and facilities in responding to anticipated needs and changes are not addressed in planning documents.

Second, equipment replacement needs are not anticipated, planned, and scheduled in a systematic way. These weaknesses impair the department's ability to recognize and address problems with current functions and to anticipate and be prepared for changes that will affect its operation in the future.

Integrated, Comprehensive Approach to Planning Is Needed. Department management acknowledged that strategic planning for future changes is an important function that is actively carried out within the agency. Each year the department's management team meets for a two-day retreat to prepare the upcoming biennial budget. The agency's only written department-wide strategic plan resulted from one of these management retreats. The plan, a *Strategic Business Plan* was developed during FY 1991 and updated in October 1991.

The first plan was described by department management as "skeletal" and as being designed "to document the planning process." A review of the 24-page plan indicates that it was too general and incomplete to be used as a blueprint for future decision-making. The business plan was also supposed to be only the first of a number of plans to be developed, including resource plans, a training plan, a facilities plan, and a technical plan. None of these other plans had been developed as of October 1991.

The updated *Strategic Business Plan* was completed in October 1991, subsequent to the JLARC review of planning documents. While the tax department is to be commended for revising and improving upon the original plan, the revised plan still falls short of being a comprehensive strategic plan.

The revised plan is not comprehensive, failing to deal with all of the department's major functions. Indeed, the introduction to the plan states, "The purpose of this plan is not to focus or highlight all of our responsibilities . . . ." JLARC staff found that insufficient attention is given within the strategic plan to compliance functions and the resources needed to maximize revenue collections. The department seems to rely on the voluntary compliance of taxpayers to ensure proper revenue collections. The plan notes the "ability to grow and adapt has been critical to providing taxpayer service levels that enhance confidence and promote voluntary compliance." However, due to "resource constraints" the department has not been able to meet the following objectives according to its revised strategic plan:

Objective: Complete an in-depth study of the agency's compliance programs and make recommendations for improvement.

Objective: Develop an automated management information system.

Objective: Develop long-range space plans that address facilities, furniture, equipment, and funding requirements.

These three objectives deal with areas noted by JLARC staff to be critical to increasing revenue collections. Other critical areas that are not mentioned in the plan include an estimate of revenue that is not collected due to underreporting or underremittance of taxes, strategies for closing the tax gap, and the effect that accurate withholding may have on voluntary compliance and the associated need to enhance compliance activities.

The updated plan also fails to integrate various components of department functioning or relate solutions to noted problems. Five "areas of emphasis" are discussed

— technology, human resources, research and development, physical plant, and funding. These areas are discussed individually without examining the effect of changes in one area on another area. Similarly, a number of changes in the external environment are noted such as an aging population, slowing economic growth, and increased dependence on automated systems. It is not clear within the plan, however, how the tax department will be affected by or respond to these changes.

Additional agency-wide planning is also completed by the tax department during its preparation of the department budget. This type of planning does not take the place of strategic planning, however. The primary focus of the budget plan is to determine the resources needed to carry out functions during the remaining year or the next biennium. Particularly in times of budget reductions, little planning for how new innovations will impact staffing, facility, and equipment needs is done as part of budget preparation. Instead, the agency typically must focus on areas in which expenditures can be reduced.

In the absence of a well-developed strategic plan, the department's planning activities generally have been completed on a compartmentalized, as-needed basis. Studies on specific topics are completed as they are needed, typically by the unit that would be affected by the study with support from the planning and management unit. With the exception of the *Strategic Business Plan* and the planning calendar, the study documents that the planning and management division completed during FY 1991 were relatively narrow in focus, typically dealing with one particular topic (Table 13).

The tax department needs to develop a strategic planning process which provides for ongoing planning and evaluation. This process should integrate changes in Virginia's population, economy, and taxpayer behavior with changes in technology, staffing, policy, and information needs. These trends and changes should be related to department operations to determine what impact they will have. This type of integrated, comprehensive approach is needed to provide overall direction to the agency.

This type of planning should be conducted to prepare for the upcoming changes in employee withholding. The State intends to discontinue the practice of over-withholding in tax year 1993. This change will most likely result in significant changes in filing patterns and revenue collections. According to the tax commissioner, as of August 1991 no planning to prepare for the change to accurate withholding had been undertaken.

Recommendation (34): **The Department of Taxation should develop a strategic planning process that takes an integrated, comprehensive approach to planning for the agency. As part of this process a written strategic plan should be developed and continually updated. The plan should consider future needs and changes that are expected to have a significant impact on agency operations, and should include input from department staff. The plan should include but not be limited to assessing the estimated tax gap and strategies to close it, collections strategies related to converting to accurate withholding, potential tax policy changes, automation and technological advances, staffing**

Table 13

Studies Completed by the Planning and Management Services Division FY 1991

Study*	Focus of the Study
Strategic Business Plan	Provides a preliminary framework for future planning and the development of additional strategic plans.
Planning Calendar for Fiscal Year 1992	Records major activities to be completed during the fiscal year for use by the department's management team.
Fiscal Year 1991 Year End Report	Details efforts made to meet the department's self-determined objectives for FY 1991.
1991 Processing Plan	Projects temporary wage staffing needs for the processing of tax returns during the 1991 tax season.
Study to Cap Cost of Returns, Instructions, Materials andPrinting	Examines ways to reduce the cost of forms and printing procedures.
Project Streamline, Initiative 18, Feasibility Study	Evaluates whether responsibility for unemployment insurance taxes should be transferred from the Virginia Employment Commission to the Department of Taxation.

*Only studies primarily completed by the Department of Taxation are shown. Reports summarizing workload or financial data or guidelines for new internal procedures are not included.

Source: Documents provided by the Department of Taxation planning and management services division in September 1991.

needs, physical plant requirements, management needs, and environmental changes that are outside the agency. The strategic plan should be submitted to the Secretary of Finance and the House Finance and Senate Finance committees.

Recommendation (35): **Responsibility for the development, monitoring, and revision of the department's strategic plan should be supervised by the**

deputy tax commissioner and assigned to staff whose primary function is to work with department management on strategic planning.

Equipment Replacement Schedule Is Needed. The department also inadequately plans for future equipment needs and costs by not having an equipment replacement schedule. Much of the work completed by department staff involves the use of sophisticated machinery. Failure to have a replacement schedule hinders the agency's ability to replace equipment before high maintenance costs and productivity losses occur. This is particularly true in cases in which large quantities of equipment were purchased at one time and will therefore need to be replaced at about the same time. The department's remittance equipment, which had become antiquated and had numerous maintenance problems, was recently replaced at a cost of approximately $563,000. The money for this equipment came from funds that were contained in the FY 1991 budget but were not expended.

Recommendation (36): **The Department of Taxation should develop an equipment replacement schedule that includes projected costs, cost savings, and any effects on efficiency or effectiveness that not replacing the equipment might have.**

Enhanced Controls to Prevent Fraud and Disclosure of Confidential Information Are Needed

A number of tax department staff have access to computerized information on STARS which could allow them to alter taxpayer information or access confidential information. Although some safeguards have been taken, additional precautions to prevent illegal acts should be considered. Some controls which may be desirable to build into STARS may be cost-prohibitive. However, there appear to be two methods to reduce the potential for such actions that would be of minimal cost — better limiting employee access to STARS screens and conducting background investigations on employees.

Access to STARS Is Not Adequately Controlled. Limiting access to STARS screens and restricting the types of actions that can be taken by department staff are the primary controls the tax department has to prevent fraud and the misuse of confidential data. Previous reviews by internal and external auditors have shown that the tax department has inadequately limited screen access in some areas.

Internal audit reports completed for three district offices during 1988 and 1989 found that employees in all three of the districts had access to screens that they did not need. In one district, inappropriate screen access resulted in the following: six employees could prevent the issuance of individual tax bills, one employee could enter on-line business refunds, one employee could enter on-line individual tax refunds, and one employee could write off an individual tax bill.

The Auditor of Public Accounts (APA), in each annual report regarding the operation of the Department of Taxation since 1986, has criticized the department for not appropriately limiting employee access to STARS data. The 1990 APA report found three of ten employees tested "had access to screens not necessary for their job duties. One of those three employees had access to cash and to account adjustment screens." Although the APA reviews have never cited department staff for fraud or misuse of information, the potential exists.

The tax department also appears to be concerned about its controls over STARS data. For example, STARS has written procedures for waiving penalty charges when a "taxpayer is penalized because of a fraudulent act of an employee of the Department of Taxation." A memorandum was also issued in July 1991 by the field services division director to division managers. This memorandum stated:

> From time to time individuals within the agency have made unauthorized access and use of confidential tax information.
>
> The confidential tax information of celebrity types is subject to the curiosity of individuals. Recently an employee accessed the confidential tax information of two public figures to see if they were married to each other. Rumor had it that they were married to each other.
>
> We can discipline personnel who do this after it is done and after the agency has experienced some bad publicity. The STARS System tells us who accessed what information. We don't need the bad publicity. We want to see that this type of thing doesn't happen. A way to do this is to block access to the confidential tax records of public/celebrity figures.
>
> Think about your area of responsibility (district area) and give me the names of those individuals that you feel their income and business confidential information should be blocked. You may be able to think of two or three.

While this limiting of access to celebrity tax records may protect their records, there is no similar protection provided for the majority of Virginia taxpayers.

STARS procedures should be strengthened to limit employee access to screens that are needed for their work and to limit the potential for fraud and other illegal activities. The 1990 APA audit of the department noted, "The Department should review all employees' STARS access and limit access to screens that are necessary for daily job functions. We again recommend the Department carefully review access requests to STARS before granting any access. These procedures should provide greater security." In addition, the tax department should identify and build other economically feasible safeguards into the STARS system.

Recommendation (37): **The Department of Taxation should follow the Auditor of Public Accounts' recommendation to review the access that all employees have to STARS screens and limit that access to screens needed to**

complete routine job functions. The department also needs to carefully review the STARS system and its current functions to determine what procedures can be added or changed to increase the security of the system and decrease the potential for fraud or other illegal activities.

Background Investigations Should Be Completed on Employees. The tax department does not complete background investigations to determine whether potential employees have criminal records; excessive credit, debts, or delinquent payments; or delinquent taxes. JLARC staff learned that in the last two years, nine actions to place liens on the salaries or wages of tax department employees had to be taken because of delinquent federal or local taxes. An additional 65 garnishment actions had to be taken due to $108,000 in unpaid employee debts during this time period. Forty-one percent of the lien and garnishment actions were taken on classified employees' salaries, with 59 percent being taken on temporary staff's wages.

Completing background investigations on employees of State agencies is not an unusual precaution. Fourteen of the 18 states JLARC staff surveyed require a background investigation on at least some of their tax department employees. Twelve agencies within Virginia complete some type of background check involving at least criminal records checks on potential employees. Seven additional law enforcement agencies in Virginia have direct access to the database that would allow them to complete the criminal record investigations themselves.

The criminal records investigations are completed by the Department of State Police at no cost to the hiring agency. (The estimated cost to the State Police department is $15 per check.) Credit checks typically cost less than $5 each, while the tax compliance checks could be completed by tax department staff. Completing these investigations would be a relatively inexpensive way to discourage employment of individuals who should not have access to tax data for criminal or financial reasons.

Recommendation (38): **The Department of Taxation should work with the Office of the Attorney General and the Department of Personnel and Training to establish policies and procedures for completing criminal records checks, credit checks, and checks to determine whether federal and State income taxes are paid. To the extent possible, initial and periodic background checks should be completed for current and potential employees.**

Recommendation (39): **The General Assembly may wish to amend the *Code of Virginia* to require the Department of Taxation to complete initial and periodic background checks on its employees.**

Identified Concerns about the Agency Should Be Addressed

Tax department management has received a number of valuable recommendations and suggestions for improving its operations in the past. Studies completed by the Department of the State Internal Auditor, the Auditor of Public Accounts, and DGS have presented a number of recommendations. Department staff have presented ideas through employee suggestion programs and in discussions with supervisory staff. It appears, however, that department management has not acted on many of the recommendations and suggestions that could result in improved operations.

Deficiencies Identified in Prior Reviews of Department Functions. Prior reviews of Department of Taxation functions have been completed. A number of these reviews identified deficiencies, some of which have not been addressed.

The Department of the State Internal Auditor reviews the internal audit functions of State agencies on an ongoing basis. The State internal audit department in its last two reports, completed in 1988 and 1991, found the tax department's internal audit function to be weak and relatively ineffective. The 1991 report noted that many of the problems identified in 1988 were still present. Some of the inadequately addressed deficiencies meant that:

- internal audit staff continue to perform functions that could threaten staff objectivity

- sufficient evidence of the unit director's review of working papers is still missing

- the standard that "internal auditors should exercise due professional care in performing internal audits" still is not met

- the percentage of time audit staff spend on special projects and administration continues to be unnecessarily high.

According to the 1991 report of the Department of the State Internal Auditor, the tax department has taken "insufficient action . . . to correct the deficiencies" that have been identified.

The Department of the State Internal Auditor gives each of the audit functions that are reviewed an overall rating. The possible ratings are: fully complies, adequately complies, and does not comply. In the 1991 report, the Department of the State Internal Auditor noted the tax department was one of seven agencies examined whose internal audit function did not comply.

The Auditor of Public Accounts issues an annual audit of the financial operations and internal control mechanisms within the Department of Taxation. During the last four years, the APA has cited the department repeatedly for improper recording of fixed assets, not appropriately limiting access to STARS, having an inadequate disaster recovery plan for automated systems, and inflating the figure of uncollectible taxes receivable (Table 14). In the APA's 1990 report, problems related to the computation of tax collection amounts, access to the Commonwealth Integrated Personnel and Payroll System (CIPPS), documentation for financial statements, and screening of some purchases were cited. The Department of Taxation's response to the audit indicated that steps were being taken to address these findings.

Table 14

Summary of Findings from Auditor of Public Accounts Reports on the Department of Taxation, Fiscal Years 1987 - 1990

Audit Finding	FY 1987	FY 1988	FY 1989	FY 1990
Fixed assets are not properly recorded	●	●	●	●
Access to STARS is not appropriately limited	●	●	●	●
The disaster recovery plan for automated systems is inadequate	●	●	●	●
Computation of uncollectible taxes receivable inflates amount that is actually collectible	●	●	●	●
Access controls to internal security system for automated data are inadequate	●	●	●	
State revenue accounts contain unreconciled errors	●			
Taxpayer accounts contain erroneous credit balances	●			
Automated system errors are not investigated and corrected	●			
Terminated employees are not promptly removed from payroll registers	●			
Split checks and checks forwarded to another unit are not deposited in a timely manner		●		
No audit trail created for the Set-Off Debt Collection System		●		
Replacement checks are not deposited in a timely manner			●	
Tax collection amounts inaccurately computed for use in the Commonwealth's Comprehensive Annual Financial Report				●
Access to CIPPS is not appropriately limited				●
Documentation for financial statements is inadequate				●
Purchases of greater than $5,000 are not screened as required				●

Source: JLARC staff analysis of the Auditor of Public Accounts' Reports on Audit for the Department of Taxation for fiscal years 1987 through 1990.

The Department of General Services completes periodic studies of the Department of Taxation's procurement process. The last DGS review of the tax department's procurement procedures was completed in May 1990. This review indicated problems with timeliness of invoice processing, documentation of contracting activities, determination of the actual price quotations, and acceptance of vendor maintenance agreements without setting conditions specific to agency needs. The Department of Taxation generally concurred with DGS findings, with the exception of the timeliness of invoice processing.

In a letter to the tax commissioner, the director of the DGS purchases and supply division also stated, "I am somewhat concerned about the fragmentation of purchasing responsibility within your organization, current invoice processing procedures, and a lack of emphasis on post award activities." The tax department did not respond to this statement since it was made in the letter accompanying the audit rather than as an official finding.

Recommendation (40): **The Secretary of Finance should ensure that the Department of Taxation implements recommendations made by other agencies such as the Department of the State Internal Auditor, the Auditor of Public Accounts, and the Department of General Services. Progress reports specifically addressing the recommendations should be made to the Secretary of Finance.**

Deficiencies Identified by Tax Department Staff. A number of employees expressed concerns about the department's operations. These concerns, and in some cases suggestions addressing the concerns, were noted on written questionnaires, within department documentation, and during interviews with JLARC staff.

Department staff noted in their questionnaire responses that morale, salary levels, communication, management, and leadership were the most problematic aspects of the agency's operation. The percentages of employees reporting that these five characteristics were problems ranged from 64 percent noting morale to 44 percent citing departmental leadership (Table 15).

When the responses of employees who did not express an opinion are removed, 70 percent of employees expressing an opinion reported that employee morale was not good. Segregating responses from staff within the three largest agency units (and removing the responses indicating no opinion) resulted in 73 percent of staff within the field services division, 79 percent of staff within the office services division, and 70 percent of staff within the processing services division reporting that employee morale was not good. Seventy-seven percent of district office staff reported that morale was not good.

In addition to being asked about employee morale in general, respondents were asked to rate their own morale (Table 16). Respondents within office services had the most negative morale ratings, followed by field services. Processing services' respondents had the most positive ratings. The five categories of factors given most frequently

Table 15

Employee Responses to JLARC Staff Questionnaire

Statement	Strongly Agree	Agree	Disagree	Strongly Disagree	No Opinion
Employee morale is good	2%	25%	32%	32%	10%
My salary fairly compensates me for the work I perform	1%	27%	41%	25%	6%
Communication within the department is good	3%	35%	35%	15%	13%
The department is well-managed	6%	32%	30%	15%	18%
Departmental leadership is good	4%	37%	30%	14%	16%

Note: Percentages may not add to 100 due to rounding.

Source: JLARC staff questionnaire of Department of Taxation staff, spring 1991.

Table 16

Department of Taxation Employee Ratings of Personal Morale

Question: *How would you rate your own morale at the current time?*

	Excellent	Good	Fair	Poor
All Respondents	11%	34%	37%	19%
Field Services Division Respondents	9%	33%	38%	21%
Office Services Division Respondents	3%	19%	48%	29%
Processing Services Division Respondents	24%	33%	30%	13%

Note: Percentages may not add to 100 due to rounding.

Source: JLARC staff questionnaire of Department of Taxation staff, spring 1991.

as having a positive influence on morale were satisfaction with work; relationships with other workers or units; the quality of supervision, management, planning, or communication; personal values or reasons; and adequacy of compensation. The five reasons most frequently given as having a negative influence on morale were adequacy of compensation; the quality of supervision, management, planning, or communication; funds, resources, equipment, technology, staffing, or training available; fairness, equity, appreciation, or trust by management; and satisfaction with work.

The fact that State workers are under a long-term salary freeze undoubtedly affected staff morale negatively. The Department of Taxation is subject to the same salary restrictions as other State agencies. Consequently, it is difficult to isolate overall dissatisfaction with State employment from dissatisfaction with the tax department. However, several of the employee comments about salary concerns did not relate to State-imposed restrictions. These comments included:

- Too many types of jobs are lumped into the grade 5 category, some are functioning as secretaries.

- Low pay due to improper classification of our cartographers seriously handicaps us in hiring the best potential staff.

- Reclassification for field representatives. We have been waiting for seven years for someone to evaluate and initiate a pay increase in line with what our job responsibilities are.

- I feel like for the length of time and the work I do I could be upgraded on the pay scale. When jobs do come up, instead of upgrading employees that have been here for some length of time, they would rather hire a temporary worker for a job with more pay than train someone that has been here for sometime. And I feel like this is unfair.

As previously noted, the adequacy of compensation was given as the primary negative influence on morale by questionnaire respondents. The department should evaluate whether internal compensation is consistent and equitable.

Communication within the department was the third most frequently cited problem by questionnaire respondents. Of employees expressing an opinion, 57 percent reported that communication was not good. Segregating responses from staff within the three largest divisions of the department (and removing the responses indicating no opinion) resulted in 55 percent of staff within the field services division, 66 percent of staff within the office services division, and 63 percent of staff within the processing services division reporting that communication within the department was not good. Sixty percent of district office staff reported that communication was not good.

Several staff in the district offices stated that they often hear about changes in tax law from taxpayers rather than from the department. According to one district staff member, "It's embarrassing when taxpayers have more current information than we have."

Department management and leadership were the fourth and fifth most frequently cited problems by respondents. Forty-five percent of respondents did not consider the department to be well-managed, while 44 percent reported departmental leadership to be problematic. A number of respondents elaborated, including more specific comments on their questionnaires. These comments reflected the diversity of opinions on these issues. Some of the comments made included:

- [I have a] very competent middle manager who allows senior agents to make decisions about their accounts and allows us to help with the plans for the office. The department allows for training of senior agents/staff which is good.

- Most of the people in my division are professionals and are treated as such by our management. I am given a job to do and am allowed to do it with a great deal of independence.

- My immediate supervisor goes the extra mile in order to see that the . . . function is administered professionally and its functions carried out to the best abilities of the staff.

- The biggest problem that I see wrong with the tax department is management, most of whom have never worked with the general public. We are managed by people who are marginally qualified to manage. These people always know easy ways to do things. But can never get any results.

- It appears that most management, instead of doing the best for all people concerned, are only concerned with their own well-being; simply put, they are totally self-serving. I find this totally absurd and the only reason I can think of is insecurity.

- Currently management spends way too much time "moving paper" and hardly anytime in the management role.

- Much less management, more working staff or more effective management/ communication. More competent middle management and no "personal pets."

- More long-range information about future developments and plans for all divisions. Hopefully, this would stop the surprise, panic, and crisis mode we can get into when something needs to be done "yesterday" or "the left hand doesn't know what the right hand is doing."

A related problem noted in analyzing survey responses was the failure to consistently complete employee performance evaluations in a timely manner. Forty-two percent, or 80 of the 190 employees who responded to the staff questionnaire, indicated that it had been more than a year since their last evaluation. A review of eight of the management team's personnel files in July 1991 showed:

- two management team members had no performance evaluation contained in their personnel files

- one management team member's most recent performance evaluation dated back to 1980

- three management team members' most recent performance evaluations were completed in 1988

- two management team members' most recent performance evaluations were completed in 1989.

Thus, none of the files that were examined contained timely performance evaluations for management team members.

Confirmation of many of the survey comments was received during reviews of agency documents and interviews with department staff. A listing of employee suggestions that had been submitted to department management in October 1990 noted "lack of communication department wide, the right hand does not know what the left hand is doing. Problems and new information are not passed on to all the people that need to know. . . ." The following comments were made during interviews with department staff:

One member of the department's management team stated she was not aware of many agency weaknesses. She further noted that "the management team concept is good to ensure structured communication and encourage informal communication."

* * *

Another member of the management team noted that one of the agency's weaknesses was that "there are too many people on the management team. I would like to see the number reduced from 14 to seven or eight. I hope that the five early retirees will result in a reorganization of the management structure."

* * *

One district office supervisor considered the department's management to be very "open-minded." He also stated that the management structure "functions harmoniously" and is "above average" on sharing information with other agencies.

* * *

Another supervisor within a district office noted that central office has been characterized as "one big, black hole." In his words, "everything you send up there goes into a big, black hole and it disappears. Nothing ever changes." He noted that he has documented problems and sent them in but "nothing ever changes." After several years of documenting the problems in the hopes of having them addressed he has just stopped.

* * *

Several auditors within field services voiced concerns about the lack of communication with tax policy. One auditor within a district office noted, "the chain of command is unbelievable." He also stated that tax policy staff will not talk to the auditors and that the auditors are not allowed to talk directly to anyone in central office. "Tax policy communicates with technical services and sometimes with the district audit supervisor."

The tax department should consider revisions to its management approaches that enable it to better incorporate employee ideas. Approaches are needed to improve quality and productivity. A mechanism for receiving employee suggestions is already in place in the department's Dialogue II program. This program involves two-way communication between employees and members of management. Elected dialogue leaders bring employee concerns and ideas to the attention of department management while a confidential request system allows employees to request and receive responses to specific questions from management. Currently, however, it appears that department management does not use the suggestions made by staff.

Private sector management techniques, such as total quality management as proposed by W. Edwards Deming and others, may be particularly relevant to the department given its function. The department, like many private businesses, must take into consideration its heavy processing demands, the need for high quality control, taxpayer (or "customer") satisfaction, and the cost effectiveness of compliance techniques.

Recommendation (41): **The Department of Taxation should identify and implement approaches to address employee concerns and ideas. Particular attention should be paid to concerns about morale, salaries, communication, management, and leadership. Having large percentages of staff reporting negative responses may indicate that these problems are impairing effectiveness. Among the approaches considered, should be the techniques proposed by W. Edwards Deming, which relate to quality control and employee involvement.**

ACCOUNTABILITY AND OVERSIGHT NEEDS WITHIN THE DEPARTMENT

Although the authority to assess and abate taxes is contained within the Department of Taxation, there are few statutory requirements for documentation or external oversight of these functions. Unlike many other states, unless a taxpayer appeals the tax department's determination of tax liability in circuit court, the department is the only entity to hear and rule on the appeal. According to department management, legal challenges of appeals are fairly rare.

This review found that internal accountability for decision-making is also limited. Generally the department lacks standards to direct abatement and audit decisions, relying instead on judgments of the staff members performing the activities. These judgments are made daily by a wide variety of staff.

The review also found that the department lacks standards for documentation. The lack of standards often results in inadequate documentation. Inadequate documentation of staff judgments makes it difficult to understand why certain decisions were made. In many instances in which documentation requirements do exist, JLARC staff found that the requirements were not being followed. This decentralized, *ad hoc* approach, which lacks explanatory documentation or oversight of the judgments made, meant that the overall impact of inappropriate decisions on revenue collections could not be determined.

Therefore, better internal accountability, through accurate documentation and clear guidelines for revenue-affecting decisions, is needed. External oversight of decisions which affect tax revenue is also needed to ensure that large sums of taxes that should be collected are not being abated.

Documentation for Revenue-Affecting Decisions Is Inadequate

In administering the Commonwealth's tax laws, the tax commissioner is granted broad latitude in making decisions that affect tax revenue. The commissioner is not required to have any department actions regarding the reduction of taxes owed approved by any outside entity. There are also few documentation requirements related to these decisions. Consequently, no effective means of ensuring accountability for revenue-reducing actions is currently in place. The JLARC staff review of offers in compromise, abatements, and audits revealed that the department's documentation of decisions which affect large revenue amounts is not sufficient to determine if these adjustments are warranted. For actions in which documentation was statutorily required, the available department documentation was inconsistent with legislative intent.

Documentation of Offers in Compromise. Offers in compromise allow a taxpayer to settle a tax bill for less than the full amount of taxes owed. The *Code of Virginia* states that compromise offers can be accepted only if there is evidence of doubtful liability or collectibility regarding the tax. Section 58.1-105 of the *Code of Virginia* reads:

> The Tax Commissioner may compromise and settle doubtful or disputed claims for taxes or tax liability of doubtful collectibility. Whenever such a compromise and settlement is made, the Tax Commissioner shall make a complete record of the case showing the tax assessed, recommendations, reports and audits of departmental personnel, if any, the taxpayer's grounds for dispute or contest together with all evidences thereof, and the amounts, conditions and settlement or compromise of same.

The *Code of Virginia* does not require the commissioner to submit documentation on offers in compromise to anyone. The Secretary of Finance indicated that during his tenure he has not received records or other documentation related to accepted offers in compromise.

A random sample of 30 files of compromise offers accepted because of doubtful collectibility were reviewed. This review indicated that the documentation was often inadequate and that departmental verification of the reasons for accepting these offers was frequently missing. Seven of these files contained verification of taxpayer claims that their assets were not sufficient for the department to collect the tax liabilities. Only four of these seven files contained financial statements on the taxpayer. If the department is taking sufficient steps to determine doubtful collectibility, it is not being documented.

In the other 23 files that were reviewed, the only evidence of doubtful collectibility was the information provided by the taxpayer in the letter to the department. For example:

> *A taxpayer submitted a compromise offer of approximately $11,000 for an individual income tax liability of approximately $55,000. The acceptance of the offer noted that "information available indicates doubtful collectibility exists." However, the only source of information in the file was the taxpayer's letter. The letter stated that the taxpayer's children would borrow money to pay the amount of the offer. The letter also stated that the taxpayer had no other financial resources, and that a financial statement was enclosed. However, the file did not contain a financial statement or any other financial information concerning the taxpayer. Therefore, the financial information used by the department as the basis for determining doubtful collectibility could not be verified.*

* * *

> *An individual submitted a compromise offer of approximately $8,000 for an income tax liability of approximately $45,000. The liability resulted after the department had converted a corporate income tax assessment to an individual liability against the responsible officer. The offer was accepted after determining that the corporation was defunct and that "the taxpayer has access to $8,000 for a limited time." However, the only substantiation of this claim in the file was the taxpayer's letter. The file did not contain a financial statement or any other verification of the taxpayer's financial status. It therefore appears that the department based its determination of doubtful collectibility strictly on the contents of the taxpayer's letter.*

In the majority of cases reviewed, no documentation was included to indicate that the department verified taxpayer claims. Instead the department appeared to rely on information in the taxpayers' letters to the department. The department's reliance on unsubstantiated claims by taxpayers is not a sound practice. The collectibility of a tax bill should be independently verified prior to accepting an offer in compromise.

Recommendation (42): **The Department of Taxation should ensure that the determination of doubtful collectibility is properly substantiated prior to accepting an offer in compromise as required by §58.1-105 of the *Code of Virginia*. File documentation should always include a financial statement regarding the taxpayer.**

Recommendation (43): **The Secretary of Finance should ensure that the Department of Taxation establishes formal written criteria for accepting offers in compromise made due to doubtful collectibility. Such criteria should take into account the taxpayer's complete financial situation.**

Documentation of Tax Abatements. There are no statutory requirements for the documentation of tax abatements. Tax abatements involve negating the original tax assessment on the grounds that the assessment was in some way improper or incorrect. Tax abatements of $250 or less may be performed by tax collections representatives, field representatives, or tax examiners. Some abatements, resulting from actions such as the taxpayer living outside the State or the correction of a processing error by error resolution, do not require supporting documentation. Approximately two-thirds of the possible reasons for abatements must be documented, including bankruptcy; federal, office, or field audit; disaster, death, or serious illness; and duplicate assessments or returns.

JLARC staff reviewed 100 randomly selected department abatement files in order to evaluate the adequacy of documentation supporting the abatement. According to written department procedures, supporting documentation was required for 90 of the abatements that were reviewed. In 15 of those files, no supporting documentation was found. In 24 other files, the supporting documentation was not adequate to justify the stated reason for the abatement. For example:

> *A withholding tax assessment was converted to an individual liability against one of the responsible officers of the business. Although the file stated that this person was "not the responsible officer," no documentation to justify that determination was contained in the file. The department abated the liability of approximately $7,000.*
>
> * * *
>
> *According to one abatement file, the department adjusted an assessment upon receipt of the taxpayer's cancelled check. The file did not contain a copy of a check or any other evidence of payment; nevertheless, an individual income tax abatement of approximately $5,000 was made.*

* * *

One assessment of approximately $1,200 that had been made by the non-filer program was abated apparently on the basis of a note in the file indicating that the individual had not been a resident of Virginia during the tax period. However, there was no documentation in the file supporting that determination.

* * *

The file of one sales tax abatement for more than $7,400 noted that a duplicate assessment had been made. However, the bill summary printout included in the file did not list a duplicate assessment.

The Department of Taxation's internal audit unit also noted documentation problems related to abatements made by staff within a district office. The 1989 report found, in reviewing the documentation provided for 20 abatements, that five used incorrect reason codes for the abatement and one abatement was inadequately documented. The report stated:

> Reason codes are an integral part of the internal control system over abatements. Internal Audit recommends that every attempt be made to document each on-line abatement transaction with the reason code which most accurately describes the transaction. Additionally, supervisors should not approve transactions which are documented with an inaccurate reason code.

Documentation of Tax Audits. During 1991, APA staff reviewed the adequacy of audits completed by field services division staff. The Auditor of Public Accounts also found documentation deficiencies. According to the Auditor:

> The Department [of Taxation] does not have either standard programs or checklists to document audit procedures and set the scope of testing .... When sampling [taxpayer records] the auditors neither document the basis for the sample nor the method to determine the completeness of taxpayer's records.
>
> The audit staff uses a microcomputer template to generate standardized report and workpapers schedules. The resulting workpapers in our sample did not clearly support the audit procedures performed, the objective of the procedures or the auditor's conclusions. Additional oral explanation of the workpapers is necessary to understand fully the extent of the audit work.
>
> Overall, the Department does not provide field auditors with standards to follow for . . . documentation of workpapers, conclusions and sampling methods. The audit process neither adequately trains the

auditors nor documents the supervisory review of the field auditor's work and conclusions.

Properly documenting offers in compromise, tax appeals, tax abatements, and audit decisions is critical to maintaining internal control and in assuring objectivity and integrity. The deficiencies noted were serious enough in nature to require immediate attention by the department.

***Recommendation (44):* The Department of Taxation should take immediate steps to ensure that complete and accurate documentation is provided for all offers in compromise and tax abatements involving reasons that must be documented. The department should work with the Auditor of Public Accounts to develop the documentation standards. Documentation requirements for both hard copy information in files and computerized data on STARS should be carefully reviewed.**

***Recommendation (45):* The Department of Taxation should establish written requirements for the documentation of audit procedures. These audit procedures should include guidelines for determining how audit samples are selected; for determining how complete taxpayer records are; for completing workpapers that clearly support audit objectives, procedures, and findings; and for requiring supervisory review of audit documentation and conclusions.**

Some Decisions Concerning Abatements and Discharges of Taxes Are Questionable

As noted previously, documentation of many of the revenue-reducing decisions was so inadequate that the appropriateness of the decisions could not be determined. The frequency with which some abatements were made, however, called into question their propriety.

The collections which resulted from the 30 largest assessments made in 1989 were examined by JLARC staff (Table 17). The dollar amount of the assessments ranged from approximately $200,000 to more than $6.7 million for a total of $28.5 million. The department assessed an additional $2.8 million in penalty and interest. By June 30, 1991, the department had abated $12.3 million and collected $8.3 million of the $31.3 million total (including assessments, penalties, and interest).

Analysis of the 30 assessments raises questions concerning department decisions to abate large portions of the assessments, and the limited collections made on the assessments.

A taxpayer received a field audit which produced an assessment of approximately $7 million in additional sales taxes for a three-year period. The department added approximately $1 million in penalty and interest for a total tax liability of more than $8 million.

Table 17

Revenue Outcome from the 30 Largest FY 1989 Audit Assessments*

	Assessed	Abated	Collected
Tax	$28,510,482		
Penalty and Interest	2,815,397		
TOTAL	$31,325,879	$12,309,029	$8,281,105

*Data are from a sample of the 30 largest audit assessments made in 1989 and reflect activity on those accounts as of June 30, 1991. As of this date, $10,735,745 not accounted for in this table was either on appeal or under review by the department.

Source: JLARC analysis of STARS data, August 16, 1991 - October 9, 1991.

The STARS system indicates that more than $4 million was abated due to departmental processing errors and corrections to the original assessment. The department accepted the taxpayer's compromise payment of approximately $4 million and collected less than one-half of the assessed liability.

* * *

The department assessed approximately $9 million in multi-state corporate tax. The assessment was based on findings from a field audit which examined two years of records. The department added approximately $1 million in penalty and interest. The total tax liability was more than $10 million.

The department abated approximately $7 million. The STARS system indicates that the abatement resulted from a revised field audit and the elimination of penalty and interest. There is no indication in STARS or in the hard copy files that the taxpayer contested the audit.

As of June 30, 1991, the department had collected approximately $4,000 on the outstanding tax liability of more than $3 million.

Similar questions were raised when the department's discharging of some tax liabilities was examined.

A taxpayer owed the State several thousand dollars in delinquent taxes. The department issued a memorandum of lien against the taxpayer in *circuit court in the late 1980s and was awarded a judgement. Sometime during the next four years, the department discharged the liability. This meant that the taxpayer would not be identified by set-off debt collection as owing taxes and would therefore be eligible to receive tax refunds. Recently, however, the taxpayer tried to sell some property. He was unable to do so because the memorandum of lien continued to be in effect in the circuit court. In order to sell his property, the taxpayer had to arrange to pay his delinquent taxes. The Department of Taxation had no record of the delinquent taxes, since they had been discharged. Therefore, a new tax bill had to be issued on the basis of the circuit court's memorandum of lien.*

* * *

Approximately ten years ago, the department was awarded an assessment of more than $5,000 against an individual who was arrested with a large sum of cash on his person. Soon after the judgement was awarded, the department discharged the liability. Since the liability was discharged, the taxpayer has been able to file tax returns and receive refunds for the last ten years. This situation would have continued if a department employee had not noticed a newspaper article about the taxpayer. The department then pursued and received another judgement against the individual which resulted in collecting the original assessment.

The lack of documentation coupled with limited oversight of these decisions meant that the magnitude of all revenue-reducing decisions made by the department could not be determined. This review showed that approximately 39 percent, or more than $12 million, was abated on just the 30 largest assessments. The department makes thousands of abatements each year. Given the effect that these large assessments have on State revenue and the size of abatements that department staff are making, the tax commissioner should be required to provide the Secretary of Finance with information on any assessments of more than $200,000 for which abatements of 25 percent or more are made.

Recommendation (46): **The General Assembly may wish to revise § 58.1-105 of the *Code of Virginia* to specify that summarized documentation of downward adjustments by any means of more than 25 percent on assessments of more than $200,000 is to be submitted by the tax commissioner on a quarterly basis to the Secretary of Finance and to any oversight entity the General Assembly creates in response to alternatives presented in the next section of this chapter.**

Recommendation (47): **The General Assembly may wish to require the Auditor of Public Accounts, as part of its annual review of the Department of Taxation, to review the documentation for these downward adjustments of more than 25 percent on assessments of more than $200,000.**

Alternatives for Overseeing Department Operations

In Virginia, oversight has been limited to relatively narrow reviews of tax department operations. Two state agencies, the Auditor of Public Accounts and the Department of General Services, complete financial and procurement reviews respectively. The APA's financial reviews generally examine the documentation and support for decisions that were made rather than establish guidelines for the making of abatement decisions. The DGS reviews are confined to determining adherence with State procurement requirements.

The tax department's own internal audit unit, which could be another source of independent review, has been found to be generally ineffective. The Department of the State Internal Auditor in its June 1991 report noted that the tax department was one of seven State agencies examined that did not comply with review standards. The report stated:

> . . . deficiencies in practice were found that were considered so significant as to seriously impair or prohibit the Program from carrying out its responsibilities.
>
> Major factors affecting the Program's overall rating were: An incomplete risk assessment and audit planning process, insufficient scope of work (as it relates to proper coverage of major departmental systems and programs), and the absence of complete documentation to support audit work performed.
>
> These issues, as well as certain other topics identified in this report, were described in this Department's August 26, 1988 "External Review of the Department of Taxation's Internal Audit Department"; and, in our opinion, insufficient action was taken to correct the deficiencies during the review period.

Specific findings related to the internal audit unit included:

- functions are performed that could impair the unit's objectivity
- comprehensive goals and objectives for audit work have not been established
- adequate auditing had not been completed in the areas of "the Processing Section, Services Section, Collections Section, and Compliance Section"
- limited effort was spent examining whether resources were used economically and efficiently or determining whether defined goals and objectives were accomplished
- documentation on some audits was lacking with no written report being prepared for two audits.

The importance and magnitude of the problems identified in this review of the tax department and the absence of effective ongoing oversight of the department indicate that additional external oversight of the tax department is imperative. Consequently, options for oversight were examined by JLARC staff.

Oversight Provided at the Federal Level. At the federal level, a number of mechanisms are in place to oversee the operations of the U.S. Internal Revenue Service (IRS). These mechanisms are located in both the legislative and executive branches of government.

Within the legislative branch of government, the U.S. General Accounting Office (GAO) and oversight committees in Congress provide oversight. GAO provides continual, ongoing oversight of IRS operations by dedicating approximately 120 staff years to its oversight of IRS on an annual basis. There is also the Joint Committee on Taxation, within the U.S. Congress, that holds hearings on tax policy issues. Four additional Congressional committees that provide periodic oversight include the House Government Operations Committee, the House Ways and Means Committee, the Senate Finance Committee, and the Senate Governmental Affairs Committee.

The oversight provided within the executive branch of government has been established by IRS. First, a division devoted to hearing tax appeals that is separate from the rest of IRS has been established. This division provides case-based accountability for the review of tax appeals. The second oversight mechanism involves several internal oversight committees that have been appointed by the IRS commissioner. These committees provide the commissioner with an independent review of research findings, tax form design, and other important agency functions.

Oversight Alternatives Used in Other States. JLARC staff surveyed 18 other states regarding oversight provisions. Eleven of these states provide for external decision making or supervision that exceeds the oversight Virginia's tax department receives (Table 18). These states have several entities or individuals who are involved in decisions affecting revenue collection.

Seven states (Delaware, Kentucky, Louisiana, Massachusetts, Minnesota, Ohio, and Wisconsin) have independent tax boards that hear and rule on tax appeals. Typically these statutorily-created boards have three members appointed by the governor.

A second oversight alternative was to have a commission, made up of three or four commissioners, to oversee department activities. Three states, California, Mississippi, and South Carolina, utilize this commission structure. Florida has the most unique structure utilizing two oversight entities.

> *In Florida, the governor and six independently-elected cabinet members control the Department of Revenue and comprise the first oversight entity. This group approves all abatement and offer of compromise decisions involving more than $100,000. The second oversight entity is a legislative audit committee that completes financial and performance audits of the department.a legislative audit committee that completes financial and performance audits of the department.*

Table 18

Oversight of Tax Departments in Selected States*

State	Tax Appeal Board	Multiple Commissioners	Other**
Alabama			
California		●	
Delaware	●		
Florida			●
Georgia			
Kentucky	●		
Louisiana	●		
Maryland			
Massachusetts	●		
Minnesota	●		
Mississippi		●	
New York			
North Carolina			
Ohio	●		
Oregon			
South Carolina		●	
Tennessee			
VIRGINIA			
Wisconsin	●		

*External supervision provided as part of the states' customary chain of command is not shown as oversight.

**Includes two levels of oversight -- an executive branch committee (composed of the governor and six cabinet members) and a legislative audit committee.

Source: JLARC survey of other states completed summer of 1991.

As noted, various combinations involving strengthening executive oversight, dividing responsibility for the agency between multiple commissioners, and providing legislative oversight were used by other states. These and other alternatives for providing oversight of the tax department were considered by JLARC staff.

Oversight Alternatives that Could Be Considered for Virginia. Sporadic, limited reviews of the department may not be sufficient considering the problems found during this review of Virginia's tax department and the importance of tax revenue collections to the State. Consideration should be given to establishing focused, on-going oversight of the tax department. Four options for providing this type of external oversight that could be used separately or in combination with others were developed by JLARC staff. Considering that the collection of tax revenue is an executive branch responsibility, the options focus on increased oversight by executive branch entities. These options include:

- establishing an independent board
- employing multiple commissioners
- imposing additional reporting requirements
- providing the Secretary of Finance's office with staff to monitor the tax department.

The first option involves establishing an independent board appointed by the Governor. This board could be used to hear and rule on taxpayer appeals as other states use their boards. Unlike seven of the states surveyed, Virginia allows the tax department to rule on all appeals of its own tax decisions. Another possibility would be to use a citizen board in a supervisory manner similar to other boards in Virginia. Some of the Virginia agencies which use boards in this manner include the Virginia Port Authority, the Virginia Department of Transportation, the Department of Air Pollution Control, and the Department of Education.

A second area in which an oversight board might be useful is in the review of tax forms. Having tax forms that are as short, simple, and straight-forward as possible saves on printing costs, reduces taxpayer errors, and encourages higher levels of voluntary compliance. According to the Commonwealth Poll, 42 percent of the respondents who had filed tax returns indicated that State tax forms were difficult or very difficult to complete. An external board could be established to review the State tax forms, to solicit input from taxpayers and tax practitioners, and to ensure that forms are as easy as possible to understand and complete.

Establishing more than one tax commissioner is a second oversight option. This option is used in some other states and is a structure used in Virginia to oversee independent agencies such as the State Corporation Commission and the Virginia Workers' Compensation Commission. Two alternative structures under this option include: (1) having different functions within the department overseen by different commissioners, or (2) requiring all of the established commissioners to approve certain specified decisions while allowing an executive director to oversee daily operations. Decisions which would need the approval of all commissioners would include revenue-affecting decisions such as the acceptance of offers in compromise and large tax abatements, discharges, and write-offs.

A third oversight option would be the clear delineation, within the *Code of Virginia,* of reporting requirements specifying information that is to be supplied to the Secretary of Finance. The department could be statutorily required to report on revenue-affecting decisions such as the acceptance of offers in compromise and large tax abatements, discharges, and write-offs.

The fourth option for strengthening executive oversight involves providing the Secretary of Finance with staff dedicated to monitoring tax department operations. The primary focus of the oversight would most likely be functions in which revenue-affecting decisions are made. These would include changes in policy or procedures to prevent the possibility of fraud or abuse related to the audit of or collection of tax revenue, annual examinations of collection and abatement activities, continuous reviews of State tax gap estimates and revenue forecasts, and indicators of progress made by the department in closing the tax gap.

External oversight of the tax department is especially important given the State's reliance on the revenue generated by the department. Therefore, decisions made about this revenue need to receive additional review.

Recommendation (48): **The General Assembly may wish to further examine options for additional external oversight of the Department of Taxation. At a minimum, any oversight entity established should review the methodology for estimating the State tax gap, procedures for closing the tax gap, significant policy or procedural changes that are likely to affect tax revenue, and procedures instituted to prevent fraud or misconduct.**

Appendixes

Appendix A

JLARC Study Mandate

Item 13 of the 1991 Appropriation Act

"The Joint Legislative Audit and Review Commission shall review the Commonwealth's executive system of financial planning, execution, and evaluation including an evaluation of the organization, management and operations of the Virginia Department of Taxation. The scope and duration of the review shall be determined by the Commission. The Commission shall report on its progress to the 1991 General Assembly Session and to each succeeding session until its work is completed. In carrying out this review, all agencies shall cooperate as requested and make available all records, information and resources necessary for the completion of the work of the Commission and its staff."

Appendix B

Department of Taxation's Statutory Responsibilities and Authority

Table B-1

Department of Taxation's Statutory Responsibilities and Authority for Administration of Individual Income Tax

Responsibilities	Authority
Design and provide tax forms	Grant extension of time to file return
Process, examine and audit returns	Require commissioners of revenue to provide local treasurers with copy of daily assessment sheet
Administer and enforce assessments	Require taxpayer to furnish copy of federal return for examination
Administer and enforce collections	Require taxpayer to report change in federal taxable income
Prescribe form of reports required of commissioners of revenue and local treasurers	Issue regulations concerning estimated taxes declaration threshold, and requiring partnerships to provide copies of federal returns
Collect payments through processing employer withholding and individual tax returns	
Transmit collections to State Treasury	
Record voluntary contributions of taxpayers	
Issue refunds	

* Includes employer income tax withholding, individual estimated income tax, partnership income tax, and fiduciary income tax.

Source: JLARC analysis of Section 58.1-300 *et seq.*, and Section 58.1-490 *et seq.* of the *Code of Virginia*.

Table B-2

Department of Taxation's Statutory Responsibilities and Authority for Administration of Retail Sales and Use Tax

Responsibilities	Authority
Administer and enforce collections	Revoke dealer certificates of registration
Administer and enforce assessments	Require dealer to testify or answer interrogatories if return is not filed
Administer and enforce penalties	Prescribe, issue, and suspend tax exemption certificates that are no longer valid
Issue dealer certificates of registration	Notify dealers that certain exemption certificates are no longer valid
Provide listing of newly registered businesses to localities	Report misuse of exemption certificates to Secretary of Finance and legislative money committees
Provide for refund of taxes paid on returned goods	
Assess tax due if return not filed, of if filed return is fraudulent	

Source: JLARC analysis of Section 58.1-600 *et seq.* of the *Code of Virginia*.

Table B-3

Department of Taxation's Statutory Responsibilities and Authority for Administration of Corporate Income Tax

Responsibilities	Authority
Examine and audit returns	Require submission of additional information to determine tax due
Assess additional amount due	
Bill taxpayer for additional amount due	Issue regulations for computing tax due when accounting method has changed
Order issuance of refund due	
Respond to objections of assessments	Issue regulations concerning declaration of estimated income
If objection — evaluate assessment method	Adjust tax due in the event of price manipulations or other transactions which affect reported income
If method inapplicable — reassess by another method	
Prescribe forms for reporting	
Furnish forms to corporations	
Issue regulations for combined returns	
Issue regulations for energy income tax credit	

Source: JLARC analysis of Section 58.1-400 *et seq.* of the *Code of Virginia*.

Table B-4

Department of Taxation's Responsibilities and Authority for Other Taxes Administered

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Estate tax	On transfer of estate of residents, nonresidents, and alien decedents	Negotiate with other taxing authorities on taxes due from "generation-skipping" transfers	Provide notice and demand for additional tax due on generation-skipping transfer Make written offer of compromise with other states on taxes due from decedent disputes Enter into agreements with other states to submit decedent disputes to arbitration	Attorney General (approves arbitration agreements)
Recordation tax	On every deed, deed of trust, and mortgage admitted to record	Notify clerk of court prior to collecting tax	Assess and collect any tax that remains uncollected for 30 days	Local clerk of circuit court (assesses and collects tax)
Cigarette tax	On sales, storage, receipt or consumption of cigarettes in Virginia	Issue regulations concerning duties of cigarette transporters Issue regulations concerning the kinds of cigarette containers to be used Issue regulations concerning methods of breaking cigarette packages	Audit and inspect records of dealers, transporters and distributors Enter premises and examine any records Issue regulations concerning sales of unstamped cigarettes by wholesalers	None

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Cigarette Tax (Continued)		Issue regulations concerning manner of affixing revenue stamps Prepare and sell revenue stamps Offer discount on sale of stamps to wholesalers Prescribe form of dealer's permit application Supply applications Issue permits to qualified applicants Assess tax due for nonfilers and incorrect returns Mail notice of assessment to taxpayer	Revoke permits	
Bank Franchise Tax	On net capital of banks	Design tax returns Credit tax liability for local franchise taxes paid Correct all errors discovered in audit	Audit returns	Commissioner of revenue (receives payment)

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Bank Franchise Tax (Continued)		If tax liability adjusted, notify local governments which also tax the bank		
Watercraft Sales and	On sale, lease, charter or other use watercraft in Virginia	Assess and collect tax Prescribe and issue dealer registration certificates	Assess tax if invoice not furnished Assess tax if invoice does not reflect true sales price Revoke dealer's registration certificate	None
Aircraft Sales and Use Tax	On the retail sale or use of aircraft in Virginia	Assess and collect tax Prescribe form of dealer tax returns	Assess tax if sales invoice not furnished Assess tax if invoice does not reflect true sales price Assess tax if aircraft purchased more than six months prior to use and storage	None
Forest Products Tax	On manufacture or shipment of forest products for sale, profit, or commercial use	Examine returns Determine proper amount of tax due	Assess tax due if return not filed with 30 days of due date	None

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Forest Products Tax (Continued)		Promptly refund overpayments Prescribe form of manufacturer's return Prescribe form of shipper's reports	Examine records of manufacturers and shippers	
Tire Tax	On sale of new tires	Collect tax Certify expenses incurred in administering the tax	None specified	None
Soft Drink Excise Tax	On sale of carbonated soft drinks by wholesalers or distributors	Collect tax	None specified	None
Motor Vehicle Fuels Tax in Certain Districts	On the retail sale of motor fuel in certain counties, cities, and transportation districts	Issue regulations for registration of dealers Issue regulations concerning procedures for filing returns Prescribe forms for refunds Issue regulations governing refund of tax	None specified	None

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Tax on Wills and Administrations	On probate of wills and grants of administration	Issue refund in event of over-payment	None specified	Local clerk of circuit court (receives filed return, receives tax payment)
Corn Assessment	Corn produced in Virginia for sale	Collect tax from handler quarterly Deposit payments into State treasury to credit of Virginia Corn Fund Prescribe form of assessment returns Supply assessment returns	None specified	None
Soybean Assessment	Soybeans produced for sale	Collect tax from handler quarterly Deposit payments into State treasury to credit of Virginia Soybean Fund Prescribe form of assessment returns Supply assessment returns	None specified	None

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Egg Excise Tax	Eggs produced or sold in Virginia	Collect tax from handler monthly Supply assessment returns Deposit payments into State treasury to credit Virginia Egg Fund	Issue regulations concerning the interpretation, administration and enforcement of the tax	Virginia Egg Board (provides advice and consent on regulations)
Peanut Excise Tax	Peanuts grown in and sold in Virginia	Collect tax from processor semiannually Assess five percent penalty if late Assess interest if overdue by 30 days Institute legal action on delinquent taxes	May inspect processor's records	None
Rolling Stock Tax on Railroads and Freight Car Companies	Tax on the assessed value of railroad cars and motor vehicle carriers	Prescribe form of tax returns Collect tax annually Determine type of equipment that constitutes "rolling stock"	Can send for persons and papers having information necessary for assessment	Comptroller (pays amount of revenue due to each locality)

Table B-4
(continued)

Tax	Brief Description	Department of Taxation's Responsibilities	Department of Taxation's Authority	Other Government Entities Involved
Rolling Stock Tax on Railroads and Freight Car Companies (Continued)		Furnish to localities listing of all real and tangible personal property of railroad and freight car companies located in the locality Assess real and tangible personal property of railroads on an annual basis Annually assess rolling stock of railroads and freight car companies Provide copies of assessments to taxpayers Determine percentage of fair market value, and percentage of miles of track in Virginia, located in each locality		
Litter Tax	Imposed on every person engaged in business as a manufacturer, distributer or retailer of one of 15 types of products	Process and audit returns Collect tax Provide forms		

Source: JLARC analysis of Sections 58.1-900 et seq. - 58.1-1700 *et seq*. of the *Code of Virginia*.

Table B-5

Taxes Administered by Other State Agencies

Tax	Administering Agency	Role of Tax Department
Public Service Corporation	SCC	Consult with local taxing districts on ascertainment and equalization of tax Notify clerk of court if commissioner of revenue fails to notify taxpayer of political boundaries of locality Prescribe forms for use in levying taxes Establish valuation of real and personal property of railroad companies
License Tax on Telephone, Telegraph, Water, Heat, Power and Pipeline Companies	SCC	Collect tax from pipeline companies Prescribe and furnish annual report forms to be furnished by taxpayers Assess property value of pipeline transmission companies
Rolling Stock Tax on Motor Vehicle Carriers	SCC	None
Regulatory Revenue Taxes of Public Service Corporation	SCC	Certify annually to State corporations the amount of money needed to reimburse costs incurred in assessing and collecting taxes on railroad companies
Road Tax on Motor Carries	SCC	Furnish to SCC the amount of deduction from income taken by any person conducting business as a motor carrier, on account of purchase of motor fuel
Corporation Charter and Related Fees	SCC	None
Motor Fuel and Special Fuel Tax	DMV	None
Oil Company Excise Tax	DMV	None
Motor Vehicle Sales and Use Tax	DMV	None
License Tax on Insurance Companies	SCC	None
Alcoholic Beverage Taxes and Licenses	ABC	None
Virginia Unemployment Tax	VEC	None
Workers' Compensation	Indust. Comm.	None

Source: JLARC analysis of Section 58.1-2020 *et seq.* of the *Code of Virginia.*

Table B-6

Taxes Administered by Local Governments

Tax	Administering Agency	Role of Tax Department
Real Property Tax	Commissioner of Revenue Assessing Officer	Establish real property classification system Prepare and issue annual assessment/sales ratio study Prescribe forms for publishing amount of local tax-exempt property Construct and maintain system for collecting real property tax facts Prescribe qualifications for and certify local assessing officers Provide continuing education for local assessing officers and boards of equalization Prescribe, prepare and furnish reassessment forms Provide advice and assistance to localities in making reassessments Certify real property of public service corporations to each county and city
Merchants' Capital Tax	Commissioner of Revenue	Prescribe and furnish forms for reporting the different classes of personal property
License Taxes	Commissioner of Revenue	Issue guidelines defining and explaining the categories of maximum license tax rates May issue written advisory opinions interpreting the guidelines
Cigarette Tax	Commissioner of Revenue	May enter into arrangement with localities concerning use of a dual stamp by a tobacco wholesaler for payment of state and local tax
Tangible Personal Property	Commissioner of Revenue	None specified

Source: JLARC analysis of Section 58.1-3000 *et seq.* of the *Code of Virginia*.

Appendix C

Glossary of Taxation Terms

Abatement The elimination of tax liability that had been assessed by the department on the general grounds that the assessment was in some way improper or incorrect. Abatements reduce both the number and dollar amount of accounts receivable.

Accounts Receivable Inventory All outstanding tax liabilities that have been assessed by the department.

Accurate Withholding The process by which an employer withholds 100 percent of the annual income tax liability from each of the employees (see overwithholding).

Assessment The same as a tax bill.

Compliance Revenue Collections Enforcement revenue collected by the department through assessments and tax bills.

Conversion A process by which the department transfers unpaid business tax liability to individual tax liability of one or more of the business' responsible officers.

CP2000 A department compliance program which uses data from an IRS comparison of income reported on federal information returns (Forms W-2 and 1099) and income reported on individual income tax returns.

Discharge The elimination of tax liability that had been assessed by the department on the general grounds that the liability is uncollectable. A discharge removes the bill from the accounts receivable inventory and from the refund/match set-off program (see write-off).

Federal Compare A department compliance program which compares the following data on federal and State individual income tax returns: federal adjusted gross income, number of exemptions, type and amount of deductions taken, and filing status. If a discrepancy appears, an audit candidate is created.

Gross Remittance Tax Gap The difference between the amount of tax that is actually due from taxpayers and the amount voluntarily paid for a specific tax period.

Gross Reporting Tax Gap The difference between the amount of tax that is owed and the amount that is voluntarily reported for a specific tax period.

Gross Tax Gap T he difference between the amount of tax that is owed and the amount that is voluntarily reported and paid for a specific tax period.

Jeopardy Assessment An immediate assessment made by the Tax Commissioner when it is determined that collection of liability will be jeopordized by delay.

Legal Sector Income Income which is earned from activities which are not prohibited by statute.

Memorandum of Lien A legal document filed by the department in the appropriate circuit court which attaches to real property owned by the taxpayer. If the property is sold prior to a delinquent tax bill being paid, the department will receive an amount from the sale proceeds sufficient to pay the tax bill.

Net Remittance Tax Gap The gross remittance tax gap minus the amount of adjustments through collections, abatements, write-offs, and discharges.

Net Reporting Tax Gap The gross reporting tax gap minus the amount of adjustments through collections, abatements, write-offs, and discharges.

Net Tax Gap The gross tax gap minus the amount of adjustments through collections, abatements, write-offs, and discharges.

Offer in Compromise Offer made by a taxpayer to settle a tax bill for less than the full amount of tax liability. The Tax Commissioner is authorized to accept an offer in compromise for tax or interest liability if there is a determination of doubtful liability or doubtful collectability.

Over Withholding The process by which an employer withholds more than 100 percent of the annual income tax liability from each of the employees (see accurate withholding).

Refund Match/Set-Off Program A process by which the department determines if a taxpayer has any unpaid tax liability prior to issuing an income tax refund. If unpaid tax liability is identified, the taxpayer's refund is reduced by that amount.

Statutory Assessment An assessment made by the department in the event that a taxpayer fails to submit a required return. Available information is used to estimate the tax due which is then usually inflated by approximately 25 percent.

Tax Bill An official notification issued by the Virginia Department of Taxation to a taxpayer stating that a specific amount of tax liability is due.

Taxpayer Appeal A taxpayer is allowed to apply to the Tax Commissioner for relief from an assessment within 90 days from the date of the assessment. Once an appeal has been filed, the department is required to stop collection activity.

TCMP An IRS program conducted every three years, which involves comprehensive audits of random samples of about 50,000 federal returns.

Write-Off The interuption of efforts to collect individual income tax liability that had been assessed by the department on the general grounds that the liability is uncollectable. A write-off bill remains in the accounts receivable inventory and in the refund match/set-off program for possible collection (see discharge).

Appendix D

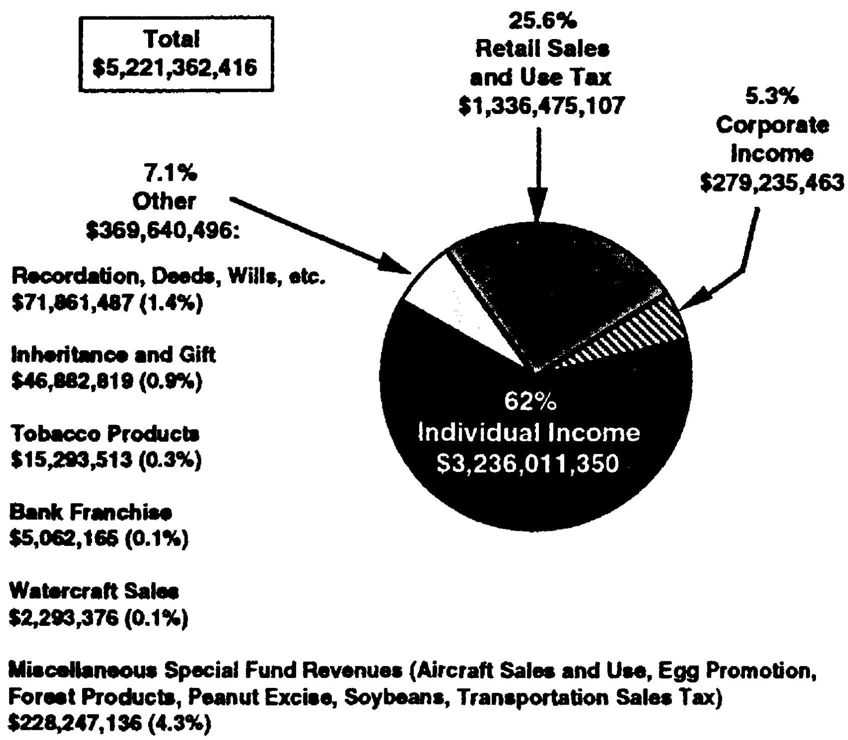
Methodology for Estimate of State Reporting Tax Gap

The Virginia Department of Taxation is responsible for the administration of 20 taxes. The three largest revenue producers are individual income tax, sales and use tax, and corporate income tax (Figure D-1). These three taxes accounted for approximately 93 percent of the total tax revenue collected by the department in FY1991.

Virginia's tax system, like the federal system, is based on voluntary compliance. Voluntary compliance is the fraction of taxes owed by individuals and corporations that are paid without direct enforcement contact. However, the federal government has estimated that the difference between the amount of federal taxes that were due but not voluntarily paid was approximately $90 billion in 1989. This difference is commonly referred to as the gross income tax gap. The major portion of that is represented by the difference in taxes actually owed and taxes voluntarily reported to IRS — the "reporting tax gap." IRS estimates that approximately $72 billion was underreported on filed returns in 1989.

Figure D-1

Department of Taxation Revenue Collections
Fiscal Year 1991



Source: JLARC analysis of Department of Taxation Data.

The methodology discussed in this appendix pertains to the 1989 gross individual and corporate income tax reporting gap, the 1989 net income tax reporting gap, and the projected 1992 gross reporting gap, unless otherwise noted. The gross income tax remittance gap and the gross nonfiler tax gap, which have also been estimated by IRS, are not addressed. Whenever the terms gross tax gap or net tax gap are used in this paper, they refer to the gross income tax reporting gap and the net income tax reporting gap, respectively.

Virginia's tax department relies heavily on data provided by the U.S. Internal Revenue Service (IRS) and IRS activities for its enforcement and compliance promoting activities. Further, Virginia is a conformity state. Therefore, the federal adjusted gross income (FAGI) serves as the starting point for the computation of Virginia adjusted gross income (VAGI) and Virginia individual income tax liability. Weaknesses in these federal data, coupled with Virginia's reliance on these data, may be keeping Virginia's enforcement efforts more limited than they could be. Therefore, it appears reasonable to assume that Virginia also has a tax gap.

At least nine other states have computed estimates of their respective tax gaps. These estimates have been used to help target enforcement activities. To date, it does not appear that Virginia's tax department has computed an estimate of Virginia's tax gap.

An income tax gap can be viewed and defined in several ways. The purpose of this paper is to outline two different concepts of Virginia's income tax gap. Each concept of the income tax gap has its own characteristics and usefulness in targeting enforcement and compliance activities. The two concepts that will be presented are the gross income tax gap and the net income tax gap.

The two measures presented are extremely conservative measures of Virginia's overall tax gap as they measure only the tax gap resulting from two taxes — corporate income and individual income. Data necessary to estimate the tax gap resulting from sales and use tax and the other 21 taxes administered by the department are not available. The gap for these taxes could not be estimated. Thus, while these estimates will understate the total tax gap for the State, they should provide reasonable initial estimates of the individual income tax gap and a lower bound for the corporate income tax gap. Therefore, the term "tax" when used in this paper refers only to corporate and individual income taxes.

The gross income tax gap, for purposes of this research, is defined as the amount of income tax that is owed but not voluntarily reported on State returns. The net income tax gap is defined as the part of the gross income tax gap remaining after the tax department has completed its compliance-promoting and enforcement activities.

It is important to note that not all of a government's tax gap can be collected. However, tax gap estimates are useful in providing focus to compliance efforts. In addition, the difference between the gross and net income tax gaps can help measure the effectiveness of a government's enforcement and compliance-promoting activities.

Prior Tax Gap Estimates

The tax gap of any government tax system can be thought of as the difference between the total amount of tax liability and the amount actually collected. Several states and the federal government have computed estimates of their tax gaps.

The IRS estimates that the total federal gross income tax gap in tax year 1989 was between $89.3 and $102.8 billion, up more than 200 percent from an estimated range of $27.9 to $32 billion in tax year 1973. The IRS has estimated that the total federal gross income tax gap will increase to between $110.1 and $127 billion by 1992. The IRS estimates that the federal net income tax gap in 1987 was between $60.7 and $72.3 billion. That is an increase of between 13 and 19 percent from an estimated range of $53.4 to $60.7 billion in 1981. The IRS has not estimated the net income tax gap for years later than 1987.

Two examples of states which have estimated tax gaps are Oregon and California. However, the methods used by the two states differed slightly. In 1989, California estimated its 1985 gross individual income tax gap. The California Franchise Tax Board received 1985 individual income tax audit data from the IRS. IRS had collected the data as part of its Taxpayer Compliance Measurement Program (TCMP.) The data related to federal TCMP-returns with California addresses. The California-address TCMP data was matched, by social security number, to 1985 California state individual income tax returns. The TCMP-derived federal income tax change was superimposed on the state return, and used to calculate the California state income tax change. California then made several adjustments to the state income tax change to produce an estimate of the state's 1985 gross individual income tax gap.

California estimated its 1985 gross individual income tax gap to be $1.9 billion or 17.6 percent of the state's 1985 individual income tax collections. This figure represents on average $160 for each individual income tax return filed for tax year 1985.

In 1987, Oregon estimated its 1985 gross income tax gap. That estimate included both individual and corporate income tax. The Oregon Department of Revenue used 1982 TCMP data to estimate the individual component of the tax gap. Oregon's percentage share of the federal tax gap was estimated by applying the ratio of federal income tax liability from Oregon sources to the federal tax gap estimate. Oregon's 1982 state tax gap was then estimated by multiplying Oregon's share of the 1982 federal tax gap by the ratio of Oregon state income tax liability to federal income tax liability. The personal income growth rate factor from 1982 to 1985 was then applied to the 1982 state gross income tax gap estimate to produce a 1985 gross income tax gap estimate. In order to estimate the corporate component of the tax gap, the department applied federal corporate compliance rates to state corporate income tax data.

Oregon estimated its 1985 income tax gap to be $146 million or nearly ten percent of the state's total income tax collections in 1985. This figure represents on average $120 for each individual and corporate income tax return filed for tax year 1985.

Virginia's Tax Gap

The Virginia Department of Taxation has not estimated the size of the State's tax gap. During a recent interview, the Assistant Tax Commissioner for the Office of Tax Operations stated that the department does not have an estimate of the total dollar amount of non-compliance for individuals or businesses. He could only report the number of individuals and corporations who are filing returns.

Virginia's income tax system is in conformity with the federal income tax system. Specifically, Virginia adjusted gross income is equal to federal adjusted gross income, with certain additions and subtractions. Noncompliance associated with the computation of federal adjusted gross income is reflected in the amount of Virginia adjusted gross income and individual income tax liability. Therefore, as a starting point, it seems reasonable that Virginia's rate of tax non-compliance is roughly proportional to that of the estimated federal non-compliance.

Virginia's tax system, like that of the federal government and all of the other states, relies heavily on voluntary compliance. Virginia's non-compliance results from the failure of individuals and businesses to file required tax returns, underreporting and non-reporting of taxable income by those individuals and businesses who do file returns, and the failure by individuals and businesses to voluntarily pay tax liability that they have reported on their returns. In addition, a portion of non-compliance may also result from unintentional errors by taxpayers in completing their returns.

Virginia currently relies almost exclusively on the results of IRS audit and information return matching activities in the performance of its own State individual income tax compliance function. The Virginia Department of Taxation receives data from the IRS on the results of its audit activities. Much of the department's individual income tax compliance efforts are based on these data. It should be noted that the department's corporate income tax audit activities are not as heavily dependent on federal data.

The quality of the data that Virginia receives from IRS is a function of the compliance activities that IRS performs. When IRS audits a taxpayer, the results of that audit are provided to the State.

Studies by GAO, IRS and others have documented certain limitations of the IRS's individual and corporate income tax compliance promoting and enforcement activities within the past few years. These four limitations increase the likelihood that IRS is unable to detect a significant portion of tax noncompliance. If the IRS does not detect income tax noncompliance, the chance that Virginia will detect noncompliance appears to be remote.

First, the IRS audit rate has declined to less than one percent of all individual income tax returns and less than two percent of corporate income tax returns. As a result, audit data that the department receives from IRS are based on a decreasing percentage of all returns filed.

Second, unlike payments to individuals, third-party payments to corporations are not subject to IRS information reporting requirements. Specifically, while income earned by individuals is reported to the IRS on Forms W-2 and 1099, income earned by corporations is not similarly reported. However, some information returns are currently filed on a voluntary basis. The lack of a mandatory program makes it more difficult for the IRS to audit this potential source of unreported corporate income. As a result, the extent of corporate non-compliance documented by the corporate audit data that the department receives is limited.

Third, a broader problem involving corporations is the complexity and size of the audits that IRS must perform. Many such audits involve "gray" areas of tax law, and frequently result in protracted litigation. Unreported corporate income can result not only from a deliberate effort to conceal, but also from an interpretation of tax law different from that made by the IRS.

Fourth, the IRS lacks sufficient resources to perform complete audits of large corporations. Therefore, agents audit issue areas in descending order of expected yield and conclude audits at the point at which they begin to generate less in revenue per audit hour then could be assessed at another corporation. This practice may result in the IRS not detecting additional audit revenue.

GAO has examined IRS tax compliance promoting activities. These studies document additional weaknesses in IRS compliance activities. For example, until 1991, IRS did not fully investigate most high-income individual nonfilers. Furthermore, GAO cited IRS for not having a systematic method of checking for underreported income or overstated deductions on delinquent returns that high-income nonfilers subsequently filed.

Given these documented problems with IRS data and given the mandate of the Virginia Department of Taxation to collect the correct amount of tax liability, it is important for the State to derive an estimate of its own tax gap. While it is not possible to collect all of a government's tax gap, an estimate of the tax gap is helpful in enabling a state to maximize collections by increasing its knowledge of noncompliance and noncompliors. Such knowledge can enhance development and evaluation of an effective and efficient strategy of targeted programs to detect and prevent noncompliance In particular, it can assist the department in determining whether it has collected the correct amount of tax liability. In addition, an estimate of the tax gap can help ensure that voluntary compliance is maximized for all taxpayer groups. An estimate of the components of the State's tax gap is helpful to set priorities for enforcement and compliance promoting activities.

JLARC'S ESTIMATE OF VIRGINIA'S TAX GAP

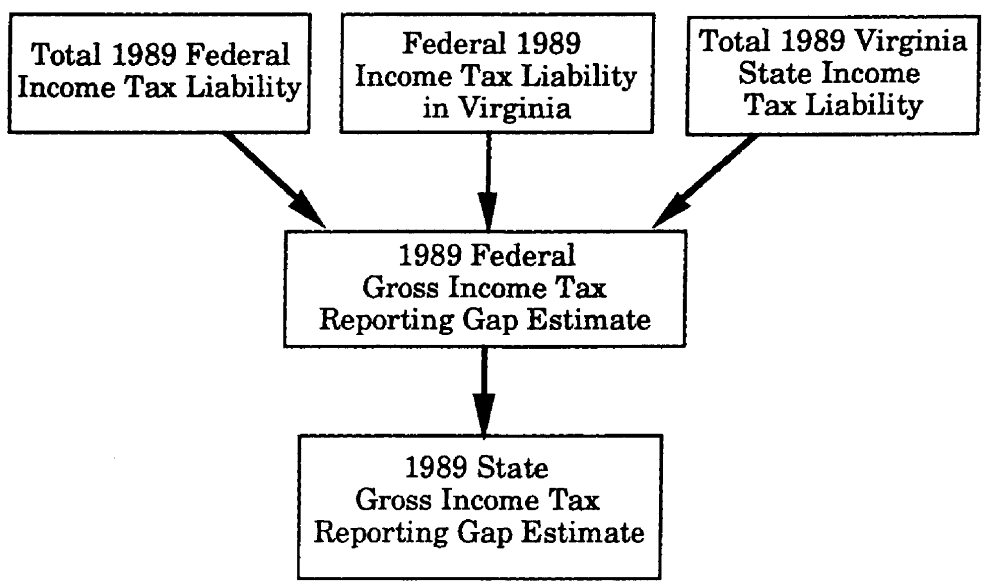
1989 Gross Income Tax Gap

The first concept is that of the gross income tax gap. The gross income tax gap is the amount of individual and corporate income tax that is owed but not voluntarily reported on returns.

JLARC has developed a methodology to compute an estimate of the State's tax gap based on this concept (Figure D-2). Two ratios are used: the ratio of federal income tax liability from Virginia returns to total federal income tax liability; and the ratio of state income tax liability to federal income tax liability from Virginia returns. These are applied to the estimated federal gross income tax gap to derive the estimated State gross income tax gap.

Figure D-2

Methodology for Estimating Gross Income Tax Reporting



Source: JLARC analysis of methodology used in prior tax gap research by Internal Revenue Service (March 1988, April 1990), Oregon Department of Revenue (January 1987), and California Franchise Tax Board (December 1989).

The basic strength of this method is that it is based on a federal estimate which has been analyzed and revised over many iterations. The federal estimate for the individual income tax gap was derived from audit data obtained from the Taxpayer Compliance Measurement Program, Phase III . TCMP is an intensive, line-by-line IRS audit of a national probability sample of about 55,000 individual income tax returns. Data are collected from every line of the return. In addition, IRS has conducted TCMP exams of corporate income tax returns of corporations with less than $10 million in assets (small corporations.) The TCMP examined small corporation income tax returns for tax years 1977 and 1980.

According to the IRS, the corporate income tax gap estimates are subject to more uncertainty than the estimates for individuals. In general, the corporate estimates are not based on TCMP data. Rather, they are based mainly on the results of special operational audits. The only exception to this is for those corporations with less than $10 million in assets. Tax gap estimates for those corporations are based on TCMP data.

There are four weaknesses to this method. These weaknesses all relate to limitations inherent to the underlying estimate of the federal income tax gap. One of the limitations is major while the others are minor by comparison. While these limitations will not invalidate the use of this method, they do need to be acknowledged.

A major limitation in the federal estimate is that, despite the intensity of the TCMP exams, some income still goes undetected. A large percentage of that unreported income may be income received in cash. During the 1982 TCMP examination, substantial amounts of income went undetected because the Information Returns Program did not cover all forms of taxable income. The IRS Research Division estimates that $142.5 remained undetected during the 1982 TCMP. Undetected income would tend to result in a downward bias in the tax gap estimates.

There are two other limitations to the estimate which are relatively minor. First, it is based on recommended rather than actual assessments after all taxpayer appeals were exhausted. Second, the number of federal returns from Virginia included in the TCMP sample (approximately 1,300 according to IRS) is small. However, these two limitations introduce relatively little bias into the estimate.

This method utilizes certain assumptions and equations. They are outlined in Exhibit D-1.

1989 Net Income Tax Gap

The second concept is that of the net income tax gap (Figure D-3). The net income tax gap is defined as the part of the gross income tax gap remaining after the department has completed its compliance promoting and enforcement, and abatement activities. This concept of the tax gap recognizes that the department does collect some portion of the gross income tax gap through its compliance promoting and enforcement activities. It also recognizes that a portion of the gross tax gap is reduced through the department's abatement of some tax liability.

Exhibit D-1

1989 Gross Income Tax Gap

Major Assumptions and Rationale

1. Virginia's State income tax gap is proportional to its share of the federal income tax gap. Virginia's share of the federal income tax gap is a function of the ratio of federal income tax liability from Virginia returns to total federal income tax liability. The State's income tax gap is a function of its share of the federal income tax gap times the ratio of State income tax liability to federal income tax liability from Virginia returns.

Rationale. Virginia's income tax is based on federal adjusted gross income. Therefore, Virginia's income tax is in conformity with federal income tax. As a result, reported federal income tax liability should be reflected in reported Virginia income tax liability.

2. State income tax compliance patterns are not significantly different from federal income tax compliance patterns.

Rationale. Virginia's income tax is based on federal adjusted gross income. The relationship between Virginia federal adjusted gross income and Virginia adjusted gross income will be assessed in depth. Between 1987 and 1989, the amount of Virginia federal adjusted gross income and Virginia adjusted gross income differed by no more than six percent.

3. The Federal Tax Reform Act of 1986 (FTRA86) has impacted taxpayer compliance. However, the IRS tax gap estimate was adjusted to reflect the impact.

Rationale. According to the IRS, by eliminating certain deductions and exclusions, FTRA86 eliminated non-compliance associated with those deductions and exclusions. In addition, because FTRA86 reduced tax rates, the average tax rate on misreported amounts tends to be lower. IRS estimated the impact of FTRA86 on compliance by reestimating the taxes of filers in the TCMP data under the provisions of FTRA86. The tax gap estimate reported by IRS was based on that reestimate.

Since Virginia is a conformity state it seems reasonable that the essential relationship between federal income tax and State income tax has remained intact. FTRA86 increased federal adjusted gross income (FAGI) which resulted in Virginians basing their state tax liability on a larger FAGI. Virginia responded to this larger FAGI by enacting tax policy changes, in 1987 and 1989, which increased standard deductions and personal exemptions and added a one-time tax credit.

Exhibit D-1 (continued)

Supporting Assumptions and Rationale

1. Some State tax collections (for individual income) have begun to decline, despite increasing taxable income.

Rationale. This was documented for the period 1985 - 1990 as part of the JLARC report State Revenue Forecasting in the Executive Branch: Process and Models. However, the reason for that decline is not fully known.

2. This method will be run three different times, each time using a different value for the variable "1989 estimated federal gross income tax reporting gap."

Rationale. The Internal Revenue Service estimate of the 1989 federal gross income tax gap was a range estimate. The method will be run using the high estimate, the low estimate, and the average of the two.

3. 1990 U.S. corporate income tax collections in Virginia is a proxy for 1989 U.S. corporate income tax liability from Virginia returns

Rationale. U.S. corporations file consolidated income tax returns. Their tax liability is computed based on income earned from operations throughout the country. The return is filed in the State in which the corporate headquarters is located, regardless of where the corporate income was actually earned. Therefore, a corporate return is considered to be from Virginia only if the corporate headquarters is located in the State.

4. U.S. corporate income tax liability increased at the same rate between 1987 and 1989 as did U.S. corporate income tax collections.

Rationale. 1987 is the most recent year for which the IRS has released corporate income tax liability data. U.S. corporate income tax collections annually increased by 6.6 percent between 1987 and 1989.

General Equations to be Used

1. Percentage of 1989 federal gross income tax liability from Virginia sources = 1989 federal gross income tax liability from Virginia returns/1989 total federal gross income tax liability

2.56% = 14,125,112,000 / 552,454,185,723

Note: 1989 federal gross income tax liability from Virginia returns = 1989 total U.S. individual income tax liability from Virginia returns + FY1990 U.S. corporate income tax collections in Virginia. The team encountered a problem with the properly defining and obtaining data for total U.S. corporate income tax liability from Virginia returns. FY1990 U.S. corporate income tax collections in Virginia was used as a proxy. (Collections made during FY1990 represent liability for tax year 1989.)

Exhibit D-1 (continued)

2. Virginia share of estimated federal 1989 gross income tax reporting gap = Percentage of 1989 federal gross income tax liability from Virginia sources X 1989 estimated federal gross income tax reporting gap

   Low: 1,828,107,131 = 2.56% * 71,500,000,000

   Mid: 2,000,690,671 = 2.56% * 78,250,000,000

   High: 2,173,274,212 = 2.56% * 85,000,000,000

Note: This equation is performed three separate times using three different values for the 1989 estimated federal gross income tax reporting gap. The high and low IRS estimates are used. In addition, a midpoint value of the estimate is used.

3. Estimated Virginia 1989 gross income tax reporting gap = Virginia share of estimated federal 1989 gross income reporting tax gap X (1989 total Virginia State gross income tax liability/1989 federal gross income tax liability from Virginia returns)

   Low: 404,630,172 = 1,828,107,131 * (3,126,428,426 / 14,125,111,000)

   Mid: 442,829,524 = 2,000,690,671 * (3,126,428,426 / 14,125,111,000)

   High: 481,028,876 = 2,173,274,212 * (3,126,428,426 / 14,125,111,000)

Note: This equation is run three times using the low, high, and midpoint estimates for the 1989 estimated federal gross income tax reporting gap.

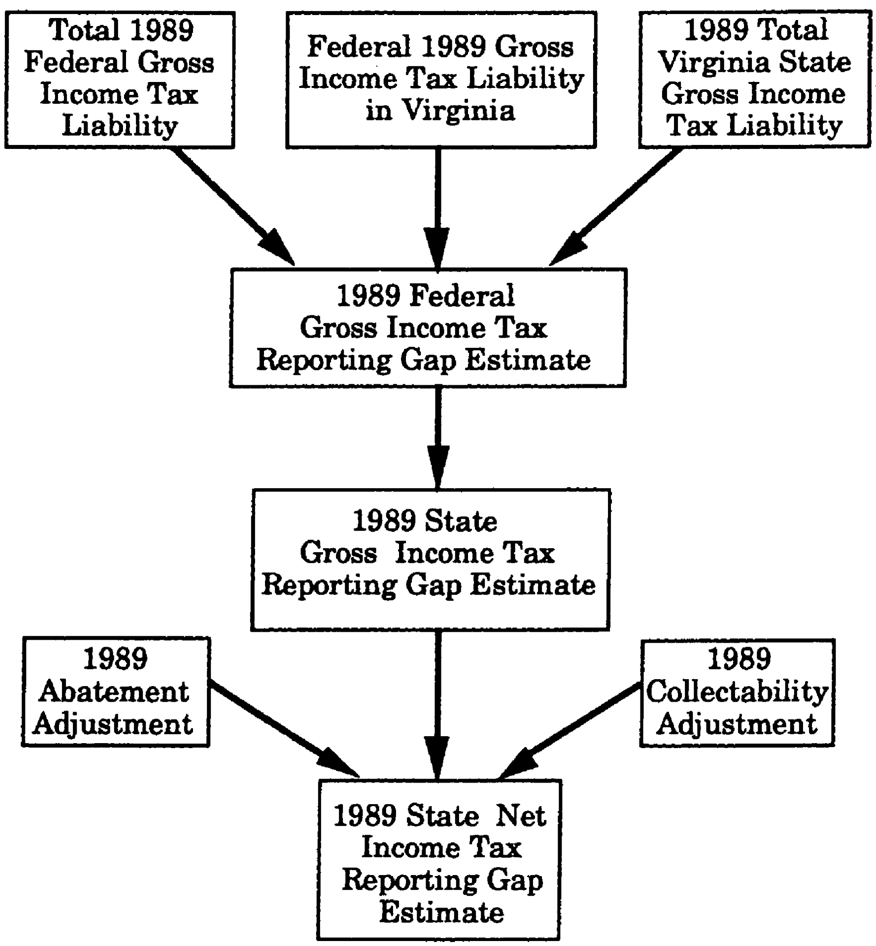
A methodology has been developed to compute an estimate of the State's tax gap based on this concept. This methodology also uses a ratio analysis based on the estimated federal gross income tax gap. The method relies on the estimated federal gross income tax gap in order to derive the estimated State gross income tax gap. Adjustments are made to the estimated State gross income tax gap to derive the estimated State net income tax gap. Adjustments are made for revenue that is reported and collected because of State enforcement, and for the effects of tax assessments that are abated by the department.

There are weaknesses to this method. While the weaknesses do not invalidate use of the method, they do need to be acknowledged. The weaknesses of this method are similar to those of method one: the inherent limitations of the underlying estimate of the federal income tax gap.

This method utilizes certain assumptions and equations. They are outlined in Exhibit D-2.

Figure D-3

Methodology for Estimating Net Income Tax Reporting Gap



Source: JLARC analysis of methodology used in prior tax gap research by Internal Revenue Service (March 1988, April 1990), Oregon Department of Revenue (January 1987), and California Franchise Tax Board (December 1989).

Exhibit D-2

1989 Net Income Tax Gap

Major Assumptions and Rationale

1. The computation of Virginia's net income tax gap begins with the gross income tax gap estimate.

Rationale. The net income tax gap is defined as the part of the gross income tax gap remaining after the department has completed its compliance promoting and enforcement activities, and abatement activities.

Supporting Assumptions and Rationale

1. Assessments are correctly abated by the department.

Rationale. JLARC staff have no alternative figures on correct abatements at this time.

2. Abated tax assessments reduce the amount of the State's tax gap.

Rationale. Generally abatements nullify assessments on the grounds that the assessment was incorrect at the time it was made. However, abatements can be made for other reasons, such as an accepted offer in compromise, a computer-generated abatement on a small balance, and waiver of penalty.

3. A portion of the State's tax gap is collected through the department's compliance activities.

Rationale. IRS estimate of the 1987 federal net income tax gap adjusts the gross tax gap estimate downward to account for amounts collected through IRS compliance activities. The Virginia Department of Taxation also collects a certain amount through its compliance activities.

4. State tax collections have begun to decline, despite increasing taxable income.

Rationale. This was documented for the period 1985 - 1990 as part of the JLARC report State Revenue Forecasting in the Executive Branch: Process and Models. The reason for this decline is not fully known.

5. This method will be run three different times, each time using a different value for the variable "1989 estimated federal gross income tax gap."

Exhibit D-2 (continued)

Rationale. The Internal Revenue Service estimate of the 1987 federal gross income tax gap was a range estimate. The method will be run using the high estimate, the low estimate, and the average of the two.

6. 1990 U.S. corporate income tax collections in Virginia is a proxy for 1989 U.S. corporate income tax liability from Virginia returns

Rationale. U.S. corporations file consolidated income tax returns. Their tax liability is computed based on income earned from operations throughout the country. The return is filed in the State in which the corporate headquarters is located, regardless of where the corporate income was actually earned. Therefore, a corporate return is considered to be from Virginia only if the corporate headquarters is located in the State.

7. U.S. corporate income tax liability increased at the same rate between 1987 and 1989 as did U.S. corporate income tax collections.

Rationale. 1987 is the most recent year for which the IRS has released corporate income tax liability data. U.S. corporate income tax collections increased annually by 6.6 percent between 1987 and 1989.

General Equations to be Used

1. Percentage of 1989 federal gross income tax liability from Virginia sources = 1989 federal gross income tax liability from Virginia returns/1989 total federal gross income tax liability

2.56% = 14,125,112,000 / 552,454,185,723

Note: 1989 federal gross income tax liability from Virginia returns = 1989 total U.S. individual income tax liability from Virginia returns + FY1990 U.S. corporate income tax collections in Virginia. The team encountered a problem with the properly defining and obtaining data for total U.S. corporate income tax liability from Virginia returns. FY1990 U.S. corporate income tax collections in Virginia will be used as a proxy. (Collections made during FY1990 represent liability for tax year 1989.)

2. Virginia share of estimated federal 1989 gross income tax reporting gap = Percentage of 1989 federal gross income tax liability from Virginia sources X 1989 estimated federal gross income tax reporting gap

Low: 1,828,107,131 = 2.56% * 71,500,000,000

Mid: 2,000,690,671 = 2.56% * 78,250,000,000

High: 2,173,274,212 = 2.56% * 85,000,000,000

Exhibit D-2 (continued)

Note: This equation is performed three separate times using three different values for the 1989 estimated federal gross income tax reporting gap. The high and low IRS estimates are used. In addition, a midpoint value of the estimate is used.

3. Estimated Virginia 1989 gross income tax reporting gap = Virginia share of estimated federal 1989 gross income reporting tax gap X (1989 total Virginia State gross income tax liability/1989 federal gross income tax liability from Virginia returns)

   Low: 404,630,172 = 1,828,107,131 * (3,126,428,426 / 14,125,111,000)

   Mid: 442,829,524 = 2,000,690,671 * (3,126,428,426 / 14,125,111,000)

   High: 481,028,876 = 2,173,274,212 * (3,126,428,426 / 14,125,111,000)

Note: This equation is run three times using the low, high, and midpoint estimates for the 1989 federal gross income tax reporting gap.

4. Estimated 1989 abatement adjusted Virginia net income tax reporting gap = 1989 estimated Virginia gross income tax reporting gap - (1989 income tax abatements)

   Low: 357,983,765 = 404,630,172 - 46,646,407

   Mid: 396,183,117 = 442,829,524 - 46,646,407

   High: 434,382,469 = 481,028,876 - 46,646,407

5. Estimated 1989 collectability adjusted Virginia net income tax reporting gap = Estimated 1989 appeal adjusted estimated Virginia net income tax gap - 1989 income tax compliance revenue payments

   Low: 325,038,729 = 357,983,765 - 32,945,036

   Mid: 363,238,081 = 396,183,117 - 32,945,036

   High: 401,437,433 = 434,382,469 - 32,945,036

Note: The above compliance revenue payment data aggregates individual and corporate bill payments and compliance deposits for tax year 1989.

1992 Projected Gross Income Tax Gap

JLARC has projected the State's 1992 gross income tax gap by extrapolating the State's 1989 gross income tax reporting gap based on the relationship between the 1989 federal gross income tax reporting gap and the 1992 projected federal gross income tax reporting gap. The projection assumes that the State reporting gap will increase at the same rate as the federal income tax reporting gap increases. The extrapolation was performed as follows:

> 1989 federal gross income tax gap/1992 federal projected gross income tax gap = 1989 Virginia gross income tax gap/1992 Virginia projected gross income tax gap
>
> $71,500,000,000/$90,400,000,000 = $404,630,172/1992 Virginia projected gross income tax gap
>
> 1992 Virginia projected gross income tax gap = ($404,630,172 X $90,400,000,000)/$71,500,000,000
>
> 1992 Virginia projected gross income tax gap = $511,588,357

This projection was computed using the low estimates for the 1989 federal gross income tax gap, the 1989 Virginia gross income tax gap, and the 1992 projected federal gross income tax gap. The assumptions associated with the projections follow in Exhibit D-3.

Exhibit D-3

1992 Projected Gross Tax Gap

Major Assumptions and Rationale

1. The growth rate in Virginia's gross tax gap between 1989 and 1992 is comparable to growth in the federal gross tax gap for the same period and reflects nationwide trends.

Rationale. Virginia's income tax is based on federal adjusted gross income. Therefore, Virginia's income tax is in conformity with federal income tax. As a result, reported federal income tax liability should be reflected in reported Virginia income tax liability. In addition, for Virginian's who file both federal and State individual income tax returns, the accuracy or inaccuracy of the information reported on the returns should be similar.

2. The 1992 federal projections made in 1990 remain accurate despite deviations from economic projections and revisions in economic forecasts.

Rationale. The IRS has not produced alternative projections for 1992.

Appendix E

JLARC/VCU Survey Methodology

A telephone survey designed to reveal aspects of taxpayer behavior and indicate the level of satisfaction with Department of Taxation services was completed as part of the July Commonwealth Poll. The Survey Research Lab at Virginia Commonwealth University called a randomly-selected sample of 1,218 households during the period of July 16 to August 1, 1991. The sample was designed so that all residential telephones, including new and unlisted numbers, had a known chance of inclusion. Interviews were completed with 804 respondents or 66 percent of all households contacted. Weights were assigned to the results based on sex, race, and education to reflect the demographic composition of the Virginia adult population.

Thirteen tax-related questions were asked of the respondents (Table E-1). Because some questions precluded a respondent from answering a subsequent question, response rates varied for each question.

JLARC staff used the sample data to make inferences for the total number of Virginia households (Table E-2). To accomplish this, JLARC staff multiplied the proportions for each question by the U.S. Bureau of the Census 1990 total number of Virginia households. The process of deriving each question's proportion and subsequent estimate followed five steps.

- First, the respondent weights were summed for all the respondents who answered the question with the same response.
- Second, the respondent weights were summed for all respondents.
- Third, a net weight sum of all respondents was derived by subtracting the weights of all respondents who refused to answer that specific question from the total sum of all respondent weights.
- Fourth, a proportion was calculated by dividing the total sum of respondent weights who answered with the same response by the net weight sum of all respondents.
- Fifth, an estimate was made by multiplying all proportions by the number of households in Virginia, 2,291,830.

When making inferences about a population from a sample, some random error due to sample selection can be expected. Sampling error was derived for each response using the 95 percent level of confidence. Therefore, a 95 percent confidence interval can be obtained by multiplying the sampling error by the total number of households in Virginia and adding and subtracting that number from the estimate.

Exhibit E-1

Number of Respondents Providing Each Answer to Questions

	Number of Respondents	Answer Category
My first questions have to do with your experience as a taxpayer in Virginia.		
1. Did you or someone in your household file a Virginia State income tax return for this past year?	681	Yes
	117	No
	4	Don't know
	2	No answer
2. Why did you not file a Virginia State income tax return?	29	Was not a resident last year
	36	Had no income
	2	Someone else did it for me
	0	Never got around to it
	2	Didn't want to
	46	Other
	2	Don't know
	0	No answer
3. Who filled out your State income tax forms this year?	241	Self
	83	Spouse
	70	Friend or Relative
	265	Accountant/Tax Attorney/Tax Prep Firm
	10	State tax assistance office
	1	Commissioner of Revenue
	3	Other
	6	Don't know
	4	No answer
4. Did you receive a refund on your State taxes?	435	Yes
	219	No
	25	Don't know
	4	No answer

Exhibit E-1 (continued)

	Number of Respondents	Answer Category
5. Was your State tax refund mailed to you in a timely manner?	405	Yes
	24	No
	4	Don't know
	2	No answer
6. Have you ever been notified by the State tax department that you made a mistake on your return?	177	Yes
	485	No
	16	Don't know
	5	No answer
7. Have you ever used any services provided by the State tax department, for example, advice in filling out the forms?	87	Yes
	582	No
	11	Don't know
	3	No answer
8. How satisfied were you with those services... were you very satisfied, satisfied, unsatisfied, or very unsatisfied?	31	Very satisfied
	43	Satisfied
	6	Unsatisfied
	3	Very unsatisfied
	2	Don't know
	2	No answer
9. Please take a minute and think about the State tax forms and the instructions and directions that come with them. How difficult would you say the State tax forms are to complete? Would you say very difficult, moderately difficult, easy, or very easy?	59	Very difficult
	222	Moderately difficult
	229	Easy
	40	Very easy
	25	Never used them
	98	Don't know
	10	No answer

Exhibit E-1 (continued)

	Number of Respondents	Answer Category
Now I have a few questions about decisions you may have made in filling out tax returns in the past. Remember that this survey is totally confidential and your name will never appear in connection with it.		
10. First, have you ever decided NOT to take an ITEMIZED deduction you thought you might be entitled to on an income tax return?	89	Yes
	459	No
	2	Never itemized deductions
	78	Don't know
	15	No answer
11. By the same token, within the past five years or so, do you think you may have overstated any deductions or expenses — even by just a small amount? Would you say you definitely have, probably have, probably have not, or definitely have not overstated any?	18	Definitely have
	25	Probably have
	164	Probably have not
	394	Definitely have not
	67	Don't know
	15	No answer
12. Within the past five years or so, do you think you may have left some reportable income off your tax returns — even just a minor amount? Would you say you definitely have, probably have, probably have not, or definitely have not overstated any?	31	Definitely have
	54	Probably have
	118	Probably have not
	402	Definitely have not
	64	Don't know
	14	No answer
13. About how many of the people that you know personally do you think do some petty manipulating of their taxes by failing to report income or overstating deductions in small amounts?	293	None
	36	One or two
	61	A few (three to five)
	23	Quite a few (six to ten)
	37	A lot (more than ten)
	218	Don't know
	15	No answer

Source: JLARC/VCU poll, July - August, 1991

Table E-2

Sampling Error and Population Estimates for Each Usable Answer, by Question

	Answer Category	Sample Percent	Sampling Error	Population Estimate
Did you or someone in your household file a Virginia State income tax return for this past year?	Yes No Don't Know	83.5% 16.1 0.4	+/- 2.6% +/- 2.5 +/- 0.4	1,913,678 368,985 9,167
Why did you not file a Virginia State income tax return?	Not a resident Had no income Someone else did it for me Other Don't Know	3.2% 5.6 0.5 6.6 0.2	+/- 1.2% +/- 1.6 +/- 0.5 +/- 1.7 +/- 0.3	73,339 128,342 11,459 151,261 4,584
*Of those who filed a State return this past year: Who filled out your State income tax forms this year?**	Self Spouse, Relative or Friend CPA or firm State Tax Assistance Commissioner of Revenue Other Don't Know	32.3% 23.6 40.3 1.7 0.1 0.5 1.4	+/- 3.2% +/- 2.9 +/- 3.4 +/- 0.9 +/- 0.2 +/- 0.5 +/- 0.8	620,553 453,407 774,250 32,661 1,921 9,606 26,897
*Of those who filed a State return last year: Did you receive a refund on your State taxes?**	Yes No Don't Know	64.0% 32.1 3.8	+/- 3.3% +/- 3.2 +/- 1.3	1,229,300 616,571 72,990
*Of those who filed a State return last year and received a refund: Was your State tax refund mailed to you in a timely manner?**	Yes No Don't Know	94.2% 5.0 0.7	+/- 1.6% +/- 1.5 +/- 0.6	1,148,474 60,959 8,534
Have you ever been notified by the State tax department that you made a mistake on your return?	Yes No Don't Know	21.7% 59.7 2.4	+/- 2.8% +/- 3.4 +/- 1.1	497,327 1,368,223 55,004
Have you ever used any services provided by the State tax department, for example, advice in filling out the forms?	Yes No Don't Know	11.5% 70.8 1.5	+/- 2.2% +/- 3.1 +/- 0.8	263,560 1,622,616 34,377

Table E-2 (continued)

	Answer Category	Sample Percent	Sampling Error	Population Estimate
*Of those who used services provided by the State tax department: How satisfied were you with those services?**	Satisfied or Very Satisfied	86.1%	+/- 2.4%	222,517
	Unsatisfied or Very Unsatisfied	11.5	+/- 2.2	29,721
	Don't Know	2.38	+/- 1.1	6,203
*Of those who filed a State return last year: How difficult would you say the State tax forms are to complete?**	Very Difficult	10.3%	+/- 2.1%	197,620
	Moderately Difficult	32.4	+/- 3.2	621,640
	Easy	32.1	+/- 3.2	615,884
	Very Easy	5.4	+/- 1.6	103,607
	Never Used Them/Don't Know	19.9	+/- 2.8	381,810
Have you ever decided not to take an itemized deduction you thought you might be entitled to on an income tax return?	Yes	10.7%	+/- 2.1%	245,226
	No	57.5	+/- 3.4	1,317,802
	Never Itemized Deductions	5.3	+/- 1.5	121,467
	Don't Know	10.0	+/- 2.1	229,183
*Of those who iled a State return last year: Have you ever decided not to take an itemized deduction you thought you might be entitled to on an income tax return?**	Yes	12.8%	+/- 2.3%	245,243
	No	68.8	+/- 3.2	1,318,179
	Never Itemized Deductions	6.4	+/- 1.7	122,621
	Don't Know	12.0	+/- 2.2	229,915
Within the past five years or so, do you think you may have overstated any deductions or expenses — even by just a small amount?	Definitely or Probably Have	5.4%	+/- 1.6%	123,759
	Definitely or Probably Have Not	69.4	+/- 3.2	1,590,530
	Don't Know	8.8	+/- 2.0	201,681
*Of those who filed a State return last year: Within the past five years or so, do you think you may have overstated any deductions or expenses — even by just a small amount?**	Definitely or Probably Have	6.4%	+/- 1.7%	122,631
	Definitely or Probably Have Not	83.0	+/- 2.6	1,590,372
	Don't Know	10.6	+/- 2.1	203,108
Within the past five years or so, do you think you may have left some reportable income off your tax returns — even by just a minor amount?	Definitely or Probably Have	11.7%	+/- 2.2%	268,144
	Definitely or Probably Have Not	63.5	+/- 3.3	1,455,312
	Don't Know	8.4	+/- 1.9	192,514
*Of those who filed a State return last year: Within the past five years or so, do you think you may have left some reportable income off your tax returns — even by just a minor amount?**	Definitely or Probably Have	14.0%	+/- 2.4%	268,380
	Definitely or Probably Have Not	75.9	+/- 3.0	1,455,001
	Don't Know	10.1	+/- 2.1	193,617

Table E-2 (continued)

	Answer Category	Sample Percent	Sampling Error	Population Estimate
About how many of the people that you know personally do you think do some petty manipulating of their taxes by failing to report income or overstating deductions in small amounts?	None	37.3%	+/- 3.3%	854,853
	One to Five	10.9	+/- 2.2	249,809
	Sx or more	7.3	+/- 1.8	167,304
	Don't Know	28.1	+/- 3.1	644,004
*Of those who filed a State return last year: About how many of the people that you know personally do you think do some petty manipulating of their taxes by failing to report income or overstating deductions in small amounts?**	None	44.6%	+/- 3.4%	854,920
	One or Two	4.7	+/- 1.5	90,092
	Three to Ten	11.5	+/- 2.2	220,439
	More than Ten	5.6	+/- 1.6	107,344
	Don't Know	33.6	+/- 3.3	644,065

Note: sample percents may not always add to 100 due to varying respondent rates.

*Question used in "Tax Reporting Behavior in Virginia."

Source: JLARC analysis of JLARC/VCU poll, July - August, 1991.

Appendix F

Agency Response

As part of an extensive data validation process, each State agency involved in a JLARC assessment effort is given the opportunity to comment on an exposure draft of the report. This appendix contains the response by the Department of Taxation.

Appropriate technical corrections resulting from the written comments have been made in this version of the report. Page references in the agency response relate to an earlier exposure draft and may not correspond to page numbers in this version of the report. Included within the Department of Taxation's response (boxed type) are JLARC staff notes for some of the recommendations. Since the release of the report, the Department has begun to implement some of the recommendations it noted in its response as invalid.

COMMONWEALTH of VIRGINIA
Department of Taxation
Richmond, Virginia 23282

December 12, 1991

Philip A. Leone, Director
Joint Legislative Audit
and Review Commission
Suite 1100
General Assembly Building
Richmond, VA 23219

Dear Mr. Leone:

As we agreed in our meeting on December 9, 1991, I am forwarding this agency's final responses to your study team's recommendations. We found 34 of JLARC's 48 recommendations to be invalid for the reasons stated in the enclosed responses. I do not believe the report provides an accurate picture of the complex issues involved with administering our tax system. Many of your recommendations outline concerns that are addressed by our management on a daily basis and that are continually addressed by the national associations of state revenue departments. Additionally, those recommendations that have merit fail to identify the resource needs that would be required for implementation.

However, the most evident concern that surfaced at our meeting was a lack of appreciation for the budgetary constraints this agency has experienced over the last three administrations. We simply cannot compete with human services, education, and other programmatic agencies for staff resources needed to perform the additional work studies and research that you believe are needed. And although we often speak to budgetary issues and staff resources in terms of compliance and noncompliance, we know that few functions we perform do not directly or indirectly support our enforcement programs.

Our noncompliance staff has remained flat over the last ten years. Our ability to maintain adequate compliance support has become critical due to budget cuts. The technologies and systems available to allow for new alternatives cannot be funded within our current budget and requests for additional funding for these projects have been denied.

Finally, I was pleased with the results of the surveys that were conducted. With 87 percent of the public being satisfied with our services and 78 percent of our employees being satisfied with their jobs, I believe this indicates that while we will continue to strive for 100 percent satisfaction, we are doing our job and doing it well.

W. H. Forst
Tax Commissioner

cc: Secretary Paul W. Timmreck

VIRGINIA DEPARTMENT OF TAXATION
RESPONSE TO JLARC RECOMMENDATIONS
December 6, 1991

I. **Recommendation 1**: The Department of Taxation should refine the JLARC reporting tax gap estimates. The department should estimate total gross and net tax gaps for the state every two years as part of its biennial planning activities. The department should develop methodologies to include sales and use taxes and the larger miscellaneous taxes in its calculations of tax gap estimates. The department estimated tax gaps should be used in departmental goal setting for audit, assessment, and collections activities each year. The department should report the results of its tax gap research as well as its plan for, and progress toward, closing the state's tax gap each year to the House Appropriations, House Finance, and Senate Finance Committees. This information should be provided as part of the department's annual budget request.

II. Response: Invalid Recommendation. Not the best use of available resources.

Justification of Response: While the idea of estimating the state tax gap has academic appeal, the application of considerable resources to estimating the gap would not be very productive.

There is no disagreement among both federal and state tax administrators that the gap exists and that it is substantial.

The IRS study of the federal tax gap has identified the types of income and deductions where compliance is lowest for individual and corporate taxpayers. These areas should not be different for Virginia. However, it has been Virginia tax policy since federal conformity legislation was enacted that the IRS conduct these income and expense audits and not Virginia Department of Taxation personnel. Virginia audit personnel are concentrated on sales tax compliance issues to avoid the duplicate cost associated with both the state and IRS conducting such income and expense audits.

Virginia may wish to estimate the tax gap for the sales tax. However, efforts may better be spent in targeting known areas of noncompliance. The department has, for instance, spent considerable energy developing programs to target taxpayers who fail to report consumer use taxes. These programs have been very successful to date, but require substantial resources to expand significantly.

JLARC Note:

JLARC staff agree with the department that efforts should be "spent in targeting known areas of noncompliance." However, JLARC staff could find little evidence that the department knows the large and small components of noncompliance nor the likely yields and costs associated with these components. For example, during the exposure period the department identified a Collections Task Force. A recent report submitted by the task force states that collections in the department are $8.3 million below the agency established objective for FY 1992. However, the task force states that this shortfall is due to a "decrease in voluntary payments by taxpayers" and therefore is "out of our control." Collections efforts should not be so dependent on voluntary compliance.

According to IRS statistics, 88 percent of the gross individual income tax gap is attributable to taxpayers who file returns but incorrectly report income or deductions. This type of noncompliance is exceedingly difficult to detect, as it involves proprietors who operate on a cash basis and may not keep accurate accounting records, and skilled or professional people who moonlight on a cash basis. It is difficult to see how motor vehicle registrations and business and professional license records could help detect this type of noncompliance, as JLARC suggests.

It is clear that pursuit of this type of noncompliance can only be done on a case-by-case basis.

As the IRS suggests, a good deal of taxpayer compliance can be improved through enhanced customer servi activities, in addition to enforcement efforts. In addition, simplified tax laws which do not change from year to year can reduce taxpayer confusion and increase compliance.

An accurate estimate of the state tax gap is not necessary to set departmental collection and audit goals, nor to assess the effectiveness of enforcement activities. Incremental goals each year would work equally well at a lower cost. It must be remembered that as the tax gap is closed, more and more resources will be required to collect fewer and fewer dollars.

III. Impact of Implementation: The IRS estimate of the tax gap is based on assessments of 1982 returns. Compliance rates for each item of income and each deduction were produced after audits were completed. Duplication of this method at the state level would require substantial compliance, audit and systems resources. The minimum funding required for a pilot program is estimated at $184,817.

IV. Legislation Required: No.

JLARC Note:

JLARC staff reject the notion that the tax gap is an "academic" exercise. It is much needed both for goal setting and accountability. To verify the importance of the tax gap for achieving these purposes, JLARC staff had drafts of its tax gap estimate reviewed by Paul Posner, Associate Director of the Tax Policy Division of the General Accounting Office and Dr. Jeffrey A. Roth, Director of the D.C. Office of Abt Associates and former Staff Director of the National Academy of Sciences Study on Taxpayer Compliance. These advisers reviewed the methods; felt the estimates were appropriate; and strongly supported the development of a tax gap estimate for Virginia.

JLARC staff also question the credibility of the department's cost estimate of $184,817. This estimate appears unreasonably high. A JLARC associate analyst was able to produce a reporting tax gap estimate for Virginia by working part-time on the effort for four months. Other than this cost, other costs incurred by JLARC in doing the estimates were several calls to the IRS Research Office in D.C. and the other state tax departments which had computed estimates. The tax department estimates that for them to do this calculation they would need three additional staff (grade 12) each of whom would need 13 weeks of training on-site at IRS in Philadelphia. This appears unwarranted and excessive.

It appears that the department may be estimating the cost of its own Taxpayer Compliance Measurement Program (TCMP). JLARC was not advocating this and does not believe that this level of effort is necessary to produce usable tax gap estimates. However, if the department conducts such a program, it should result in revenue increases. JLARC staff note that the offsetting increased revenues produced by this effort has not been acknowledged or estimated by the department.

I. **Recommendation 2**: The Department of Taxation should review the tax gap methodologies used by other states and the IRS in developing its own tax gap estimates. Further, the department should review the strategies used by other states and the IRS for improving its compliance collections efforts.

II. Response: Invalid Recommendation. Standard practice.

Justification of Response: The Department of Taxation currently keeps abreast of collection strategies used in other states and by the IRS through conferences and professional organizations, and through its work with the Southeastern Association of Tax Administrators.

The department disagrees that resources should be devoted to developing a state tax gap estimate. Howevei one were to develop such an estimate, a review of methods used by other states would be a natural undertaking.

III. Impact of Implementation: None.

IV. Legislation Required: No.

I. **Recommendation 3**: The Department of Taxation should begin to analyze its abatement data to better determine the reasons for abatements. This analysis should be used to improve collections of assessments and to reduce the percentages of abatements.

II. Response: Invalid Recommendation. Analysis already in progress (see response to Recommendation 44).

Justification of Response: A permanent Abatement Quality Control Committee was established at the department in the spring of 1991. The committee conducts samples of abatements to ensure consistency with established internal procedures. In addition, the department's internal auditor conducted an abatement study in 1989.

The ongoing analysis conducted by the Abatement Quality Control Committee will be furthered by the recent (August 1991) creation of the Accounts Receivable Task Force (see response to Recommendation 4). A key element of the task force's mission is to identify areas where further attention can be devoted to eliminate erroneous assessments before they are issued. Examples of avoidable department or taxpayer errors contributing both to accounts receivable and abatements are data entry errors and improperly credited payments.

There are numerous other factors, not isolated only to Virginia, which contribute to the large volume of abatements by the department and tax agencies in general. One such factor is the level of aggressiveness of a tax agency's compliance efforts. An aggressive program such as Virginia's will make use of tools such as the "statutory" assessment (an assessment issued when a taxpayer fails to provide necessary tax information). These assessments, which are issued only after repeated attempts at taxpayer contacts, are an essential enforcement tool in that they encourage recalcitrant taxpayers to furnish sufficient information to allow determination of the exact amount of tax due.

III. Impact of Implementation: None as two-pronged analysis of issue is currently underway.

IV. Legislation Required: No.

JLARC Note:

Based on documentation submitted by the tax department, JLARC staff cannot determine if the Abatement Quality Control Committee has examined whether required supporting documentation is being included in the abatement file. Such a review on the part of the committee is not specified in committee memoranda provided to JLARC. The lack of necessary documentation to support abatements was the focus of this section of our report.

The Collections Task Force has made several recommendations for short term strategies to improve collections. The status of implementation of the recommendations is unknown. The task force did not make any recommendations for long term collections strategies. The task force did report some "thoughts" to enhance future collections. One of those was the creation of a "master collection plan," which the department apparently lacks at the present time.

I. **Recommendation 4**: The Department of Taxation should begin to better analyze its accounts receivable inventory. This analysis should include a decomposition of the accounts receivable inventory using components which can affect collectibility. At a minimum, this decomposition should include an analysis of length of time that the tax has not been paid by type of tax and by financial status of the taxpayer. Further, the accounts receivable inventory should be maintained in such a manner that the data on each individual receivable can be determined without having to perform analysis of individual tax screens.

Once this analysis has been completed, it should be used in three ways. First, the department should develop a collectibility assessment of the inventory. Second, the collectibility assessment should be used to develop guidelines and priorities for collecting the tax. Third, the department should begin to experiment with, and track the results of, randomized experiments to test methods of collections such as mail, telephone, and in-person collections techniques. The results of these experiments should then be used to develop a standard set of guidelines for collections of the accounts receivable. The department should establish an annual accounts receivable collections goal and monitor progress toward that goal.

II. Response: Invalid Recommendation. Analyses already in progress.

Justification of Response: Growing accounts receivable inventories are a problem not only for Virginia, but also for the Internal Revenue Service and tax agencies in other states. The federal government's accounts receivable backlog has been well documented; however, GAO and IRS both recognize that the backlog will be hard to address without a modern information system. Virginia currently possesses such a system, which will give the department the ability to more efficiently deal with the backlog in the future.

The department's success at collecting accounts receivable when compared to the IRS is also documented. The most recent Finance Receivables Report prepared by the Department of Accounts noted that the department's average time to collect delinquent accounts is only 38 percent of IRS's average collection time and concluded that "[g]iven the nature of their accounts, the Virginia Department of Taxation is doing an excellent job of managing their receivables."

JLARC acknowledges that the department's tracking of accounts receivable have improved. Faced with increasing backlogs, the department initiated efforts to capture additional information on the nature of its accounts receivable in January, 1991, through development of the Accounts Receivable Aging report (TXPARB4). As additional information became available, the department created an Accounts Receivable Task Force in August, 1991, to provide a monthly analysis on accounts receivable components and trends.

The Accounts Receivable Task Force will hasten further improvement by identifying areas where further attention can be devoted to eliminate erroneous assessments before they are issued. Examples of avoidable department or taxpayer errors contributing both to accounts receivable and abatements are data entry errors and improperly credited payments.

The department already prepares or is analyzing the feasibility of preparing many of the analyses recommended by JLARC:

- Decomposition of the accounts receivable inventory: The existing Payment Activity (TXPAR98 and TXPIR98) and Accounts Receivable Aging reports provide such an analysis.

- Aging of accounts receivable by type of tax: The Accounts Receivable Aging report is currently being evaluated for expansion purposes by the accounts receivable task force.

- Determination of collectibility: By definition, the Accounts Receivable Aging report provides such an assessment. Without added cost constraints, historical collection percentages provide ample information to assesses the collectibility of the department's accounts receivable inventory.

The department already employs guidelines and priorities for collecting the tax. The department's STARS collection tracking module is based on assessments over time. In addition, collections efforts are based on a descending dollar amount. Given the department's current budgetary constraints, the collection efforts are tuned to the collectibility of assessments.

Further, the department already experiments or has experimented with, and tracks or tracked the results of randomized experiments to test methods of collections such as mail, telephone, and in-person collections techniques. The department already developed a standard set of guidelines for collections of the accounts receivable based on the results of such experiments.

The department has already established an annual accounts receivable collections goal and monitors progress toward that goal. The department's Productivity Inventory Reporting Tracking System (PIRTS) report provides a monthly and year-to-date goal.

JLARC correctly noted that the department does not maintain the accounts receivable inventory in such a manner that data on each individual receivable can be determined without having to perform an analysis of different tax screens. Such a capability was planned in the original STARS implementation effort. However, due to differing taxpayer identification numbers used for the major business taxes, this would have required significant manual effort which would have detracted from more critical agency operations.

The department also does not incorporate information on the financial status of taxpayers in determining the collectibility of assessments. This is due to the prohibitive cost of credit checks for all past due accounts, based upon the standard $15 credit bureau charge for a credit check. Further, these checks may be of limited value as they only indicate whether the individual or business is credit worthy. Due to the costs involved, an initial feasibility study on the usefulness of credit information would appear more appropriate.

III. Impact of Implementation: The department currently generates or is evaluating the feasibility of generating most of the analyses recommended by JLARC. However, the integration of taxpayer receivables and the use of credit information would require significant additional funding and are of uncertain value in improving the collections process.

IV. Legislation Required: Appropriation required.

JLARC Note:

The department acknowledges the problem of tracking accounts receivables, but not its magnitude — over $404 million as of June 30, 1991. Efforts to date, while improving, have not been sufficient.

JLARC staff acknowledge that the department's tracking of its accounts receivables inventory has improved. Some of this improvement may have been due to the influence of the task force. However, no documentation submitted by the department indicates that this task force or any group or individual has conducted systematic experiments to test methods of collection to determine effectiveness.

As detailed in DOA's Critical Agency Performance Standards (Quarterly Secretarial Review of the Secretary of Finance December 4, 1991), the Department of Taxation is cited as being "not in compliance" in all eight of the standards used to evaluate the collections and documentation of accounts receivable in this report.

I. **Recommendation 5**: The Department of Taxation should fully analyze the results of tax amnesty to determine what information can be used to better focus collections of the remittance tax gap. At a minimum the department should determine the number of taxpayers who filed during tax amnesty but did not file the following tax year. Using this information, the department should assess taxes for these taxpayers and then institute collections activities to obtain the revenue.

II. Response: Invalid Recommendation. Post-amnesty compliance efforts already underway.

Justification of Response: The department's ability to readily capture and utilize tax amnesty data was compromised by the limited up-front funding the agency received to carry out the program. Nonetheless, the department has utilized business tax amnesty data in its compliance programs and is taking steps to capture information on individual amnesty filers.

Businesses requesting amnesty were added to the tax rolls. At that time determination was made on future filing requirements. Currently STARS controls the compliance of all active business accounts by placing the account in the collection process if the business fails to file and/or pay as required.

During amnesty, 1,231 new individual taxpayers were added to the tax roll, resulting in collections totaling $3,035,230.74. If these taxpayers do not file returns for 1990 or subsequent taxable years, Va. Code § 58.1-312 grants the department an unlimited period for assessment of the proper tax due.

Programming required to determine those amnesty filers who did not file 1990 or a subsequent year's returns is planned but has not yet been completed due to a lack of programming resources. This is not yet a critical project as 1990 returns were not due until May 1, 1991, and there is no statute of limitation on nonfilers.

III. Impact of Implementation: None as post-amnesty compliance efforts are already underway.

IV. Legislation Required: No.

JLARC Note:

Final analysis of the department's response will require further review by JLARC. However, the department's response does not indicate how many new business taxpayers were added to the tax rolls as a result of tax amnesty. In fact, the department did not code businesses added to the tax roll during tax amnesty. Consequently, records of those businesses cannot be retrieved by the department. This appears to pose a serious obstacle to the department's ability to follow-up with businesses added during amnesty.

I. **Recommendation 6**: The General Assembly may wish to consider amending Section 58.1-462 of the Code of Virginia to delay the implementation of accurate withholding.

II. Response: Valid Recommendation. However, the recommendation is based upon an incorrect interpretation of the law.

Justification of Response: JLARC's recommendation is based upon an incorrect interpretation of the law, but may be advisable for other reasons. JLARC makes the erroneous assumption that the law change to take effect on January 1, 1993, will eliminate all over withholding with a potential impact of up to $220 million. First, the $220 million reported in the draft should be $140 million as the original estimate did not account for returns on error. Second, the JLARC interpretation will lead to a considerable amount of under withholding from many taxpayers.

The law change was not intended to eliminate all over withholding; rather, it was intended to allow itemizers a voluntary election to claim additional withholding exemptions (see Department of Taxation legislative impact statement on 1989 HB 1950). Furthermore, despite the existence of similar provisions at the federal level, over 70 percent of federal returns continue to reflect over withholding.

Based upon the voluntary nature of the election and federal experience, the department estimates revenue losses of only $15 million in FY 93 and $5.2 million in FY 94.

III. Impact of Implementation: Further deferral of the law change would increase General Fund revenues by $15 million in FY 93 and $5.2 million in FY 94.

IV. Legislation Required: Yes.

JLARC Note:

Documentation submitted by the department does not indicate how the numbers submitted in the legislative impact statements were derived. Therefore, the department's estimates of approximately $15 million in FY 1993 and $5.2 million in FY 1994 remain questionable.

The JLARC report does not infer or state that all of the $140 million due to over-withholding will not be collected. The point made in the report and reiterated in this response is that more information and analysis is needed to determine the actual impact of the change. Given that the department did not submit its analysis, JLARC staff believe that the report findings continue to be valid.

The JLARC "error" in reporting $220 million rather than $140 million was based on the erroneous figure that was originally supplied by the Department of Taxation. JLARC staff question which number supplied by the tax department is more reliable and valid.

I. **Recommendation 7**: The Department of Taxation should begin developing strategies for collecting taxes from individual taxpayers under a system of accurate withholding. The department should conduct research to determine reasons for noncompliance by individuals and begin to address those reasons. The department should submit a plan to the House Appropriations, House Finance, and Senate Finance committees outlining collections strategies and projected changes in revenue collections with accurate withholding.

II. Response: Invalid Recommendation. Incorrect interpretation of law (see response to Recommendation 6). The department has already conducted significant research into the potential impact of the law change (see Department of Taxation legislative impact statement on 1989 HB 1950).

Justification of Response: JLARC makes the erroneous assumption that the law change to take effect on January 1, 1993, will eliminate all over withholding.

The law change will affect only itemized filers and will be completely voluntary. In fact, federal experience with a similar provision has shown that over 70 percent of all returns continue to reflect over withholding. Similarly, the Tax Commissioner currently may grant additional withholding exemptions upon request; however, these requests have been extremely rare.

The prior federal and state experience coupled with anecdotal evidence that taxpayers overpay taxes as a means of forced savings reasonably suggest no dramatic change in taxpayer compliance as the result of the law change.

III. Impact of Implementation: As evidence previously compiled by the department suggests no significant changes in taxpayer behavior, the impact upon the department would be minimal.

IV. Legislation Required: No.

I. **Recommendation 8**: The Department of Taxation should revise its methodology for setting its compliance revenue collections goals. The department should not base its collections goals on past collections but should base its collections goal on outstanding liability due the state. In order to do this, the department should analyze and refine the JLARC estimates of underreported and underremitted tax liability and determine a collectibility factor for each. The number of personnel assigned to revenue collections should continue to be a factor in the equation.

II. Response: Invalid Recommendation. Current methodology misunderstood (see also responses to Recommendations 1 and 2)

Justification of Response: The department's compliance revenue collections goals is not used to compute the amount of revenue due the state but not collected. It is easier to estimate revenue loss than it is to find out who is not paying taxes and whether such taxes are collectible. Thus the department's estimates are designed to calculate the amount of revenue which can potentially be collected with current resources.

The department believes it should continue to base its collections goals on historical collection data, taking into consideration outstanding accounts receivable due the State. The study implies that the goal setting process does not consider outstanding accounts receivables; however, outstanding accounts receivables are considered as part of the current process. Because recent IRS and GAO studies question the ability to collect "tax gap" revenues through expanded enforcement efforts alone, relying on such estimates to arrive at a realistic compliance revenue collections goals is impractical.

III. Impact of Implementation: None. Identifying additional revenue that could potentially be collected would have no impact on the department's ability to collect outstanding accounts receivable.

IV. Legislation Required: No.

JLARC Note:

As used by the department their "goal" is merely a projection of results from current collections practice adjusted for changes in staffing levels. There is no way of knowing whether the collections goal base was established accurately. JLARC staff believe that the department should use exploratory research to determine whether more ambitious goals might be set perhaps by the better use of resources, such as shifting resources to discrete projects designed to reduce particular components of the tax gap. Such strategic thinking led IRS to vastly expanded information returns matching programs which have proven cost effective. Such breakthroughs may also be possible for Virginia's tax department in reducing components of its remittance gap or in reducing gaps in sales and use taxes.

I. **Recommendation 9**: The Department of Taxation should not routinely use field representatives and auditors to provide in-office taxpayer assistance for forms completion or to correct simple processing errors. A toll-free telephone number for taxpayer assistance that directs calls to the Taxpayer Assistance Unit within the central office or to local commissioners of revenue should be established. In conjunction with this toll-free telephone number, a taxpayer assistance position should be placed in each of the seven district offices outside of Richmond. A second taxpayer assistance position should be considered in the Norfolk, Northern Virginia, and Roanoke districts if the toll-free taxpayer assistance number does not divert enough telephone calls to allow one position to handle the demand in those districts.

II. Response: Partially valid. Funding issues are involved.

Justification of Response: Taxpayer service is an important function, and virtually every employee in the department, including the Tax Commissioner, is involved in providing taxpayer assistance during some portion of the year. There is not a dichotomy between compliance and taxpayer assistance: educating taxpayers is the fastest route to increased voluntary compliance. Although improvements in voluntary compliance are not easily measurable, IRS Commissioner Fred Goldberg has said, "It's all about maximizing voluntary compliance."

Field personnel are no less involved in compliance activities when they assist taxpayers; in fact, keeping in touch with the questions and problems of taxpayers is essential for every department employee. In any event, the demand for individual income taxpayer services has grown over the past few years, but it is unclear as to whether that trend will continue in the district offices.

The increasing number of localities who are utilizing on-line individual income tax processing and access to STARS information should significantly enhance their ability to provide taxpayer assistance. Further, there is little question that total centralization of taxpayer assistance is not an acceptable alternative for the public.

As a result of the Teletax System installed in 1990, taxpayers can now get answers to routine and recurring questions via a recorded message 24 hours a day, seven days a week. This system handled 266,817 inquiries during 1991. In addition, the automated refund system allows taxpayers to check the status of pending refunds - all that is required is a touch-tone telephone. The automated system handled 142,221 of these calls in 1991. These technological advances alone have improved our ability to handle routine taxpayer inquiries from Richmond.

The current correspondence backlog in the individual income Taxpayer Assistance Unit exists primarily due to mandatory staffing reductions. Additional funding is already needed simply to keep current with correspondence; the diversion of all or most field functions to the central office would require even more funding. Absent this type of funding, the diversion of taxpayer assistance simply says that direct compliance should and does take priority over assisting those taxpayers who legitimately desire to comply with the tax laws.

A toll-free telephone number for taxpayers has been studied before. All of the department's forms and instructions advise taxpayers of the department's central office telephone number and/or the commissioner of revenue's telephone number. Also, tax preparers and the public are advised to contact the central office or the commissioners of revenue for assistance.

While the department does not object to the concept of providing taxpayer assistance personnel for district offices, we do believe that the distribution and assignment of these personnel should be based principally on the volume of taxpayer assistance and an analysis of the volume trends. The department is in the process of organizing an interdivisional taxpayer assistance project team which will no doubt consider these recommendations.

III. Impact of Implementation: The estimated annual costs of this proposal are as follows:

Taxpayer Assistance Positions in District Offices and Richmond: (Annual costs including salary and benefits)

$451,224 - annual costs
$ 15,300 - start up costs

Toll-Free Telephone Line: $350,000 annually

IV. Legislation Required: Appropriation required.

JLARC Note:

JLARC staff do not question the need for the provision of taxpayer assistance. JLARC staff do question the use of compliance staff — tax examiners, auditors, field representatives, and collections representatives — to routinely provide that assistance in lieu of their primary revenue-generating functions. The department currently has 51 staff dedicated specifically to the provision of taxpayer assistance.

The department in its cost estimate documentation for this recommendation, also states that 18 staff will be needed to complete the taxpayer assistance that ten staff provide now. The recommendation in the JLARC report is to place a taxpayer assistance position in each of the seven districts outside Richmond. A second position should be placed in up to three districts *if* the toll-free telephone number does not divert enough telephone calls. Thus the number of district office positions, at least initially, should be seven rather than 10 as shown in the tax department's cost estimate. The department's cost estimate also shows that eight additional taxpayer assistance positions would be needed in the office services division. The need for more than three additional staff within the office services division has not been documented.

The $10 million increase in State revenue which the report documents could be collected if compliance staff were able to devote the time spent on taxpayer assistance to compliance activities. Further, compliance staff generally cost more than taxpayer assistance personnel.

I. **Recommendation 10**: The Department of Taxation should improve its capability to identify and correct tax return errors through automated error resolution, before the error results in a notice being sent to the taxpayer. If certain errors still occur, they should be handled by the taxpayer assistance section. The department should analyze the types of errors that persist and improve error resolution to correct them.

II. Response: Invalid Recommendation. This recommendation appears to be based on a misunderstanding of how the department is organized and how errors are created and resolved.

Justification of Response: Errors are created by the taxpayer before submission and by the department during processing of the return. It is felt that efficiency of the automated system has been maximized and that the system corrects errors when appropriate and when the integrity of the system is not at risk.

The department identifies and corrects tax return errors through the automated system before the error results in a written notice to the taxpayer if no further examination of the return is required and if there is no indication of fraud. Returns are automatically corrected when the system-computed tax is five dollars or less out of tolerance with the amount of tax computed by the taxpayer, and in other cases where management has determined that sufficient data is available for the system to resolve the error without an operator. The system corrects mathematical errors, computes any applicable refund or tax due, penalty, and interest. Taxpayers are automatically notified and/or billed for the additional revenue.

The Taxpayer Assistance Section should not handle errors which the system cannot resolve. The function of the Error Resolution Unit is to determine if system identified errors that are not automatically resolved are valid. When an unresolved error exists, the system-calculated information and the taxpayer-calculated information are displayed on a screen. Error resolution technicians review documentation attached to the return or additional information requested from the taxpayer to ensure that no keying errors are present and to determine which calculations are valid.

The types of errors that persist are analyzed on a continuing basis. Information is evaluated and requests for systems modifications or forms changes are reviewed regularly to reduce errors or improve error resolution.

III. Impact of Implementation: Not applicable.

IV. Legislation Required: Appropriation required.

I. **Recommendation 11**: The Department of Taxation should include only those collections resulting from direct enforcement actions by the department as compliance revenue. The department should reassess its definition of compliance revenue and exclude automatic payments which have been received without a notice or other form of direct enforcement action.

II. Response: Invalid Recommendation.

Justification of Response: In 1986, department staff met with the Secretary of Finance to establish compliance objectives and arrive at an agreed to definition of compliance revenue. The department does not object to changing the definition of compliance; however, it will have no impact on total revenue.

JLARC recommends that revenue received after the due date and before the first billing not be included in compliance revenue. Although this money is not a result of direct enforcement activity, it is a gauge used to monitor many of our compliance programs including changes in filing patterns and the effectiveness of penalties and compliance due dates. Additionally, this money is included on the theory that without our penalties, field force, billing systems and other compliance methods, these monies may become delinquent and a higher risk of noncollectibility.

III. Impact of Implementation: None.

IV. Legislation Required: No.

JLARC Note:

The department is correct in that changing the definition of compliance revenue will not produce more revenue in itself. However, the change will help the department compare the relative yields of programs to increase voluntary compliance with the yields of enforcement programs. The results of such a comparison is important to allocate resources efficiently. Further, the current definition is simply misleading.

I. **Recommendation 12**: The Department of Taxation should pilot test using selected Virginia data ~~returns~~ which supplement limitations in federal audit data to target enforcement activities on high income non-filers, sole proprietors, informal suppliers, and other groups known to have a high probability of underreporting and underremitting tax liability. The department should evaluate the pilot information to determine collectibility from these groups.

II. Response: Invalid Recommendation. Not cost effective.

Justification of Response: The department already audits a higher percentage of returns than the IRS - 11 percent by the department compared with 0.8 percent by the IRS. The department is also considering other programs to identify nonfilers (some of which are highlighted in the draft report) and continues to study ways it can identify nonfilers within current budgetary constraints.

Since Virginia is a conformity state, the most cost effective nonfiler programs are those where federal data is readily available. If a program is instituted where federal data is not available, the benefit of conformity is eliminated. Staff would have to be able to complete a federal return and then prepare the state return. Because the Virginia income tax rate is so low, this is not the most cost effective means of identifying tax revenues due the state.

Implementation to the extent recommended could require considerable funding. Current staff are not experienced in doing federal income and expense audits. The department would require a unit of highly trained tax investigators armed with considerable resources. In order for such a pilot test program to produce collections at the same rate as current staff collections ($385 per staff hour), each staff person would have to uncover $18.5 million of unreported taxable income annually (assuming that 75 percent of all assessments were actually collected). This would translate into the identification and assessment of 37 taxpayers per staff person per week, who were not reporting an average of $10,000 of income each.

The IRS is currently working to improve collections from nonfilers. It is experiencing difficulty in maximizing collections from "tax gap" activities by enforcement efforts and has embarked on a series of workshops, among other things, aimed at increasing voluntary compliance by small businesses and other taxpayers.

Instituting a full scale program may also be premature given the level of cooperative programs between federal and state tax authorities. For example, the Federation of Tax Administrators (FTA) is studying programs to enhance the sharing of information between the IRS and states, including joint auditing, joint administration, etc. The IRS has created a National Director of FedState Relations and published a FedState Handbook which lists a catalog of over 100 joint projects and pilots with states.

III. Impact of Implementation: Whether such a program could produce collections with the same degree of efficiency as existing programs and what the net effect on collections would be cannot be estimated without further study. A minimum of $184,817 would be needed to hire and train just three staff persons to pilot this program.

IV. Legislation Required: Major legislation and appropriation required for full implementation. Pilot unnecessary.

JLARC Note:

The use of other State data to supplement federal return data does not require using highly trained audit staff to conduct the expense audits as stated in the department's response. The need would be for the same types of audit staff currently working in the department. The department seems to have again taken an overly pessimistic approach to a recommendation for additional collections activities. The discussion of expense audits serves to detract attention from the central premise of the recommendation which is to supplement federal information with State information.

Again, the department lists costs but does not acknowledge nor estimate the amount of additional revenue which could be produced from this effort. Given that the majority of the components identified in the recommendation are individuals involved in social networks, the deterrence effects of pilot programs in this area could produce substantial revenue for Virginia as it has for other states.

I. **Recommendation 13**: The Department of Taxation should evaluate its audit selection procedures for corporate income tax in order to identify the specific procedures which result in the most effective audits. The department should use its findings as the basis for establishing standardized and objective criteria for audit selection.

II. Response: Invalid Recommendation. Standard practice.

Justification of Response: The department has specific and objective audit selection procedures which have proven to be very effective in maximizing revenues. Such procedures are distributed to and consistently used by all auditors. The procedures provide for the screening of all corporate returns to identify those most likely to produce additional assessments. The returns are then reviewed and/or audited in the Compliance Section. All multi-state corporate returns are then forwarded to the Field Services Division. No field auditing is done on 100 percent Virginia corporations since we do not audit federal income and expenses.

The Field Services Division uses specific and established procedures to identify the most cost effective on-site income audits. These procedures provide, among other things, that before a field audit is approved on a multi-state corporate income tax filer, an auditor must review the Virginia and federal tax returns in twelve areas, including, but not limited to ACRS additions and subtractions, dividends, foreign source income and expenses, allocable income, apportionment factors (property-sales-payroll), and taxes. In addition, the nexus issues are examined. Only if this review reveals that the performance of the audit will be cost effective, will the audit be performed.

Several years ago the department considered automating the audit selection process for corporate income tax. It was found that automating this process would require a major system change as a significant amount of data which was needed for such a system was not being captured by the department. It was determined that return from implementing this program would not offset the costs of the additional resources (both personnel and budget) needed. Thus, it was rejected.

III. Impact of Implementation: None.

IV. Legislation Required: No.

JLARC Note:

The report acknowledges that there are lists which identify certain situations which indicate that a taxpayer may be considered for an audit. Use of these lists is not, however, "standard practice." In addition, according to the APA review these lists still rely on auditor judgement and are therefore subjective. Since there are no uniform criteria used by the auditors, the decisions are inconsistent.

Further, JLARC staff interviews with auditors indicated that there was both confusion and inconsistency regarding criteria for audit selection. To the extent that the department does have "specific and objective audit selection procedures," they are not universally understood or utilized.

I. **Recommendation 14**: The Department of Taxation should establish and implement a retail sales and use tax audit selection strategy which is consistent and not subjective. The department should assess the comparative effectiveness of criteria such as the "8/83" listing, the ratio of taxable sales to total sales, and criteria used effectively by other states in developing its strategy.

II. Response: Invalid recommendation. Standard practice.

Justification of Response: The department has an objective audit selection process consisting of core criteria which is designed to maximize revenues. These criteria are distributed to all auditors and are consistently applied by all districts. These criteria include, but are not limited to:

information received from other auditors;
business trends;
past audit history;
SEATA referrals;
new businesses; and
contractors.

The assignment of audits is made by audit supervisors after reviewing recommendations submitted by auditors based on the above.

In addition, the 8/83 listing (8 percent of businesses paying 83 percent of the tax) is also used effectively in each district. Those businesses which have been identified as good audit candidates are entered into an audit tracking system which automatically reassigns the audit to the audit supervisor of the district performing the last audit for review and reassignment. The department is currently looking into the possible use of a selected 8/83 printout which lists the information in groups of business codes.

While the department's criteria are objective, some degree of subjectivity is involved in the audit selection process in terms of strategies to uncover other audit candidates and the need to recognize regional peculiarities.

The department, and particularly the Integrated Audit Committee, for some time has been looking into an automated audit selection process. In addition, audit supervisors in conjunction with the Integrated Audit Committee are looking into the ratio of taxable sales to gross sales, along with prior audit history, to develop an automated selection process. However, differences in reporting by dealers will have an impact on the development and effectiveness of this method. In addition, it is important to note that more tax revenues are derived from use tax assessments than sales tax assessments. Thus, the effectiveness of a ratio of taxable sales to gross sales approach may be limited.

III. Impact of implementation: $16,000 associated with system changes requiring 10 weeks of systems time in order to generate the selected 8/83 printout which will list the information in groups of business codes. This project is currently on the Information Systems Division's modification backlog.

IV. Legislation required: Appropriation required.

I. **Recommendation 15**: The Department of Taxation should develop standards for audit procedures ~~following generally accepted accounting principles~~. These standards should be written and disseminated to all audit staff.

II. Response: Invalid recommendation. Facts are misrepresented.

Justification of Response: The department did not have the opportunity to review the APA audit and comments and cannot therefore assess their findings. The Field Services Division has a state tax audit manual which has been in existence for many years and which is updated periodically. It incorporates procedures and techniques evolved over a period of years which have been proven to be sound and practical. Each auditor has been provided a copy of the manual on diskette. Hard copies of such, as well as a Sales and Use Tax Audit Program User's Guide (a guide to computer program applications), are contained in each district office. Audit supervisors are responsible for instructing the auditors on the contents of the manual and for monitoring the auditors' audit results to ensure that established procedures are being followed. Classroom training is also provided to auditors in both the manual and the tax laws.

Since sales and use tax audits differ substantially from other types of audits due to the fact that in many instances the taxability of an item is determined by how the item was used (exempt or taxable) or if the tax was collected and remitted, the audit manual covers auditing techniques for several types of businesses to facilitate the audit process and ensure uniform application of the tax.

Thus, the manual (which contains proven audit procedures and techniques), the classroom training, and the monitoring and review by the audit supervisor are adequate to ensure that high quality audits are being completed.

III. Impact of Implementation: None.

IV. Legislation required: No.

JLARC Note:

The Tax Department, despite numerous requests by the APA staff, had not provided a sales and use manual to the APA until December 11, 1991. A review of this manual indicates that its procedures provide general guidance to auditors, but the manual lacks specific direction in the areas noted in the report.

I. **Recommendation 16**: The Department of Taxation should continue to use federal data to identify individual nonfilers. However, the department needs to examine the feasibility and cost effectiveness of computer matches with state databases to identify and locate additional nonfilers. The department should establish pilot programs to match various existing databases with state tax return records. The department should contact other states which are using computer matches to identify nonfilers. Using available information, the department should develop a systematic approach to evaluate the available databases, the costs of the matching activities, and the potential for identifying nonfilers with each source.

II. Response: Valid Recommendation. Funding is not available for full implementation; already under study.

Justification of Response: While a systematic approach to evaluating existing databases is a great idea, the department does not currently have the resources necessary to implement such a full-scale program. The department has considered a number of programs to identify individual nonfilers (a number of which have been identified in the draft report) and will continue to study the most cost-effective methods of working nonfiler initiatives with current resources. Consideration has to be given to the potential loss of revenue from other programs when considering a new pilot program. Consideration also has to be given to the fact that not everyone is required to file a return and nonfiler programs result in refunds as well as assessments. The department is always interested in knowing what programs have been successful in other states and would be very interested know the identity of the "four other states" referenced on page 83 of the draft report.

The current method of working nonfilers not only identifies a large number of taxpayers, it also provides federal data which is necessary in the preparation and completion of examinations/reviews since Virginia is a conformity state (i.e., federal adjusted gross income, filing status, exemptions, standard vs. itemized deductions, etc.). Current methods enable the department to quickly and efficiently examine/review a large number of audit candidates. The high level of efficiency of the program is due in large part to our laws being generally in conformity with federal tax law. For this program, actual collections per staff hour are in excess of $400.

As part of the Governor's <u>1990 Project Streamline</u>, a Task Force was formed to evaluate a cooperative initiative. Recommendation 2 of the final report submitted by the Task Force included Item #4: *Sharing of automated databases.* This option would provide on-line access to a variety of computerized information between appropriate state agencies.

DPB, in conjunction with the department, studied the feasibility of implementing a Licensing Setoff Program in 1988. Based upon the study, a narrowly focused program involving the department, VEC, and ABC was implemented and that program is being evaluated to determine if an expanded setoff program is feasible. The department is now considering the feasibility of pilot testing a nonfiler program on licensed professionals with the Department of Commerce.

III. <u>Impact of Implementation</u>: In order to use database matches, some state agencies will have to redesign application forms and develop computer programs to produce information necessary for the program. Implementation will also require the development of interagency agreements and procedures. The department would incur program development costs and annual program operating costs. In many instances, staff would have to be shifted from existing programs and the outcome does not appear to be cost effective. Depending upon the information that could be provided by state agencies and other database sources, costs to implement the program could be substantial. Further study would be necessary to determine the costs to implement this program and the net effect on collections.

IV. <u>Legislation Required</u>: Because of concerns expressed by several agencies, including the Virginia State Bar during the 1988 Setoff Study, legislation requiring agencies to exchange database information with the department would be necessary. Appropriation required.

I. **<u>Recommendation 17</u>**: The Department of Taxation should prepare and implement strategies for systematically matching data in its business tax registration database with data from the Virginia Employment Commission, State Corporation Commission, and other appropriate state agencies. The department should establish pilot programs to match various existing databases. The department needs to develop a systematic approach to evaluate the available databases, the costs of the matching activities, and the potential for identifying nonfilers with each source.

II. <u>Response</u>: Valid Recommendation. Resources not available for full implementation; already under study.

Justification of Response: In conjunction with the Governor's 1990 Project Streamline, a Task Force was formed to evaluate cooperative initiatives. Recommendation 2 of the final report submitted by the Task Force included Item #4: *Sharing of automated databases*. This option would provide on-line access to a variety of computerized information between the appropriate state agencies. This exchange of information between agencies could allow the department to systematically identify potential business nonfilers.

Based upon the 1988 Licensing Setoff Study by DPB and the department, a narrowly focused program involving the department, VEC, and ABC was implemented to identify ABC licensees who owed taxes and that program is being evaluated to determine if expanded setoff programs are feasible. The study identified nine State agencies with which the department could interface.

The department also works with the State Lottery Department to conduct a tax check on each applicant for a lottery retailer license.

III. Impact of Implementation: Implementation will require the development and approval of interagency agreements, program development costs, system modifications, and procedures. It may also require other agencies to redesign application forms and develop computer programs to produce information necessary for the program. The minimum amount of program development costs that would be incurred by the department equal $19,280. Depending upon the information that could be provided by state agencies, the costs to implement such a program could be substantial. Further study would be necessary to determine the costs to implement this program and the net effect on collections.

IV. Legislation Required: Because of problems expressed by several agencies, including the Virginia State Bar and other regulatory agencies during the 1988 Setoff Study, legislation mandating that other state agencies furnish the department with the appropriate information would be necessary. Appropriation required.

I. **Recommendation 18**: The Department of Taxation should track the current status of all tax assessments made by each of its various compliance programs for each year. The amount of the total assessments that have been collected, abated, or discharged should be monitored. The information should be used to evaluate the quality of audit assessments and effectiveness of collections activities.

II. Response: Invalid Recommendation.

Justification of Response: The department tracks compliance programs, but refinements in the analysis of current data can always be made. The department presently monitors data on the collections, abatements, discharges, and write-offs of all of the individual compliance programs. A systems request is pending for the production of similar reports on corporate compliance programs. In addition, random samples of field assessments are done on a periodic basis.

The current monitoring reports allow the department to evaluate the quality of audit assessments and the effectiveness of collections activities. The department would have to weigh the systems costs with any potential improvements in the department's ability to evaluate the quality of its compliance programs.

The department does **not** agree that it is necessary to track **each** bill. While this information would be nice to have, the benefits would be insufficient to justify the substantial expenditure of the system resources necessary to produce it.

III. Impact of Implementation: The department's ability to evaluate the quality of audits and the effectiveness of collections activities would be marginally enhanced. Additionally, study to determine the most cost-effective system changes would have to be made before an accurate cost projection can be done.

IV. Legislation Required: Appropriation required.

I. **Recommendation 19**: The Department of Taxation should ensure that all uncollected business tax assessments are converted prior to the expiration of the three-year statute of limitations.

II. Response: Valid Recommendation. Currently under consideration.

Justification of Response: Two system modification requests are currently pending, one of which would ensure that all operating units are provided lists of accounts required to be converted within 60 days of expiration of the three-year statute of limitation and another which would expand the types of businesses whose delinquencies are automatically converted. Neither modification has been begun due to inadequate resources. Also under consideration is an automatic corporate officer conversion when a business declares bankruptcy.

Additionally, the normal audit cycle for a business is approximately 30 months in order to assess within the three year statute of limitations. The statute of limitations for converting assessments to corporate officers runs from the same starting date. Therefore, in many audit assessments, there is a maximum of six months from the ending date of the audit period until the statute of limitations for converting the assessment expires.

Further, the statute contains a stringent test in order to legitimately assert corporate officer liability which must be proven in most cases prior to collection. Therefore, many converted assessments are not easily collected.

III. Impact of Implementation: Completing the two system modifications identified above would cost approximately $26,000. In addition, it is estimated that six additional collection representatives, at an annual cost of $164,412, would be required to support collection or resolution of bills generated by such a program.

IV. Legislation Required: One of the most beneficial methods for enhancing the department's ability to convert and collect assessments would be to extend the statute of limitations for conversion from three years from the date the tax became due and payable to three years from the date of assessment. Appropriation required.

I. **Recommendation 20**: The Department of Taxation should enter the necessary data and modify STARS programming to ensure that all of a business' accounts balances are checked before any refunds are issued for that business. This programming should ensure that no refund is issued unless all of the accounts have been paid in full.

II. Response: Valid Recommendation. Insufficient funding and resources.

Justification of Response: It is true that there are many businesses operating under more than one account number. Most of these existed prior to the implementation of the STARS Registration Module, but many have occurred subsequent due to the fact that several people within the department are allowed to register a business. This situation will occur when an operator is registering a business for a specific tax and is unaware that it is already registered for another tax. When this happens, a business is then registered under more than one account number and thus any refunds that are generated for one account number are in fact not "linked" to the other account number. There are no statistics available to determine the magnitude of this problem; however, the best way to identify like businesses operating under more than one account number would be to produce a name comparison report of all businesses with similar names and have the Registration Unit attempt to combine as many like accounts as feasible using the "210 Combine Registration" Screen. This mechanism currently exists.

It is not feasible to have the refund match process attempt to recognize businesses with different account numbers prior to issuing the refund. The legal business name would have to be used to recognize like businesses, and due to name misspellings, abbreviations, and the variety of ways a business may be registered, the system may not catch as many candidates as it could and would catch many that it should not. Either way, a manual review would be necessary.

III. Impact of Implementation: To implement the name comparison report would require approximately two weeks of systems programming and, depending on the number of candidates identified on the report, may require as much as six man-months of one full-time person to do the manual research and subsequent combining of accounts. In addition, because there are current known limitations with the combining process, several changes may be required to the "210 Combined Registration" screen. This may require an additional two to three weeks of programming changes.

IV. Legislation Required: Appropriation required.

JLARC Note:

The department acknowledges that some businesses are continuing to be registered under more than one account number. The department originally told JLARC that was a problem only for those businesses registered prior to 1983. Therefore, the impact of this situation on business refund set off is even more problematic than described in our report.

I. **Recommendation 21**: The Department of Taxation should modify STARS programming to provide for a "write off" capability for business taxes.

II. Response: Valid Recommendation. No funding for implementation.

Justification for Response: The Department of Taxation recognizes the need for the "write off" transaction in business tax. A systems request for the transaction was made in May of 1987.

III. Impact of Implementation: It is estimated that it would require 2,170 man-hours to implement the request. This would include a screen to enter the transaction changes to the accounting updates to post it and changes to numerous accounts receivable reports to include the transaction. Additional Information Systems Division resources may be required to do this recommendation depending on the desired implementation date.

IV. Legislation Required: Appropriation required.

I. **Recommendation 22**: The Department of Taxation should modify its procedures to enable district office staff make local deposits of state tax payments into the general fund. The department should request assistance t. the Office of the Auditor of Public Accounts to ensure that necessary safeguards are followed in setting up and depositing into the accounts.

II. Response: Valid Recommendation. No funding for implementation; additional study needed.

Justification of Response: Although the recommendation is a valid one, additional study is required to determine if a cost-effective mechanism exists and to develop a solution that does not compromise the department's ability to resolve problems caused by missing or misapplied payments. Additional resources and equipment would be required for which funding is not available.

All payments processed at the department, including those payments initially received in the district offices, are processed utilizing NCR remittance processors. Among other functions, this equipment "reads" account information from the payment document and the check, encodes the check, microfilms the check and payment document, and transmits the data required to update the payment information to the STARS system. Any mechanism which allows the deposit of the taxpayer's payment by the district office must replace the above functions, or at least compensate for their absence.

The decision was made in 1985 that the most cost-effective method to accomplish the timely deposit of field office receipts was overnight delivery by courier service to our headquarters. This allowed us to take full advantage of the benefits offered by our remittance processing equipment and allowed for the timely update of complete payment data to the STARS system where it was then available along with microfilm of the check and payment document to all operators. This decision was approved by the Treasurer and the Comptroller.

However, with the appearance of new, less-costly remittance processing equipment, it may be time to reevaluate this decision. Table-top remittance processors have recently been introduced which may be useful in depositing checks in the district; however, the limitations of this type of equipment are not known. If this new equipment could not complete the necessary microfilming tasks, the agency would be placed in the position of having to respond to taxpayer inquiries and missing or misapplied payments without the availability of a microfilmed copy of the taxpayer's check. This would have a significant detrimental effect in resolving problem accounts when the check was deposited locally.

Regardless of the mechanism developed for depositing revenues in the district offices, significant programming would be required to allow the microfilm and payment information to be utilized by the STARS system.

III. Impact of Implementation: Additional study to determine the feasibility of depositing payments in all district offices, as well as the most cost-effective mechanism for depositing payments in the district offices, must be conducted before an accurate cost projection can be provided. However, with the information presently available, it is estimated that the cost for hardware acquisition and systems implementation would be $240,000. In addition, the equivalent of three additional employees would be required to support the deposit process on an ongoing basis.

IV. Legislation Required: Appropriation required.

I. **Recommendation 23**: The Department of Taxation should ensure that the Information Systems Division consider and implement appropriately those employee suggestions which have a direct and cost-effective impact on the amount of compliance revenue the department can collect. Further, the department should not continue to purchase data tapes which it does not have the capacity to read. The department should either develop the capacity to read the tapes or discontinue their purchase.

II. Response: Employee suggestions - Valid Recommendation. Insufficient Funding.

Data tapes - Invalid Recommendation. Circumstances described previously corrected.

Justification of Response (Employee Suggestions): All necessary mechanisms are already in place to ensure that the Information Systems Division appropriately consider those employee suggestions which have a direct and cost-effective impact on the amount of compliance revenue the department can collect. However, additional systems resources for which funding is not available would be required to ensure that these suggestions are implemented in a timely manner.

Over the past several years, the agency has spent a significant amount of its data processing resources on legislative changes and the maintenance of STARS. The agency's data processing resources are utilized based on the following priority:

maintenance or problem fixing;
mandated, legislative or policy related changes; and
modifications or enhancements.

Maintenance requests represent correcting problems, abends, and out-of-balance situations. This requires a substantial amount of resources due to the complex integrated tax systems and the number of unforeseen exception situations which arise that may have not been fully tested when the systems were designed. In addition, the number of program changes made over the past five years as a result of legislative changes or agency policy changes (i.e. adding a new tax; changes to returns) has had a significant impact on maintenance requirements. Some systems have relatively few maintenance problems, while others require significant resources in order to keep the systems operating effectively. The STARS system requires maintenance to over 1,800 source modules, 300 on-line screens, and 70 data bases. The agency averages over 250,000 transactions a day and support must be provided to a number of outside state agencies and localities, as well as in-house users. The manual responsibilities associated with supporting the STARS automated systems requires constant training to new users, updates to procedures, and maintenance to over 2,000 reports that are produced and distributed.

The second group encompasses a variety of assignments. For the most part, this group represents the yearly legislative changes passed by the General Assembly. The remaining tasks that fall into this category include changes due to operating policy changes, projects that involve the IRS, other states, other state agencies or local governments, JLARC requests, Auditor of Public Accounts requests, Department of Accounts directives, research requests (revenue projecting), etc. Because of the nature of the requestor, these requests are given a high priority. Because there is a much higher emphasis being placed on exchanging information with other entities, projecting and/or increasing revenues, and reporting compliance, there has been a significant increase in the number of these types of requests over the last two years.

The third group, having the lowest priority, is in-house requested modifications and enhancements. This group includes a variety of assignments, but basically represents changes to an existing process, a request for a new report or screen, or a "better way" of performing a current function. Some of these requests could be very beneficial to the agency, and in most cases, save significant time or money. Many would have a direct and cost-effective impact on the amount of compliance revenue the department can collect.

The first priority of Information Systems personnel is to minimize the backlog of outstanding maintenance requests. Resources are then assigned to mandated, legislated, or policy-related changes. Any remaining resources are utilized to work requests for systems enhancements.

User groups, whose members are assigned by agency management, are responsible for assigning the priority of outstanding systems enhancement requests. Weighing concerns of all user areas of the agency and considering the potential cost-saving/revenue-generating impact on all aspects of agency operations, the user groups determine which enhancement requests are worked when systems resources are available. Because systems resources are limited, the user groups additionally must consider the resource impacts associated with each enhancement request as provided by Information Systems personnel. Because of the low priority set on these requests, it may be years before many of the enhancement requests are worked. Other more complex requests may remain unassigned because of limited systems resource availability.

Justification of Response (Data Tapes): In the past, two tapes were purchased which the agency was unable to process. These were the IRS's Business Master File (BMF) and Business Return Transaction File (BRTF). Tl agency did not purchase these tapes for 1991. A STARS program has been developed for the Compliance Section to allow utilization of the BMF tape. A STARS program is currently being developed for the Research Division to allow utilization of the BRTF tape. Both programs will initially run using the 1989 and 1990 data which was previously purchased. After these programs are implemented, there will be no tapes purchased by the agency which will not been utilized.

III. Impact of Implementation (Employee Suggestions): Resources would be required in the Information Systems Division to support development and implementation of system enhancements suggested by employees.

Because resources have not been allocated to work modification requests in several years, the backlog of requests has grown to over 130. Some of these requests involve simple tasks, such as changes to existing reports. Others, however, involve new application system modules such as a Miscellaneous Taxes Module, an Estate Tax Module, a Data Management Module, and a Technical Assistance Module These would require significant resource expenditures. Some of the requests overlap each other, so it is likely that some requests would not be relevant once other requests are completed. Approximately 80 percent of the modification requests pending would have at least some effect on compliance revenues.

To resolve all pending systems modification requests would require approximately 20 - 25 additional resources for the first two years, and ten resources for a third year. Subsequently, eight to ten resources would be required on an ongoing basis to remain current on employee suggestions assuming they continue to be received at a rate that is approximately the same as they have been received in recent years.

Impact of Implementation (Data Tapes): No additional impact.

IV. Legislation Required: No.

I. **Recommendation 24**: The Secretary of Finance or Department of Taxation should request that the Department of Information Technology conduct a systems analysis of STARS to address the current deficiencies in the system and to determine long-range requirements. At a minimum, the following issues should be examined:

- Does STARS effectively serve all units within the Department of Taxation?
- To what extent and by what means does STARS need to interface with outside entities?
- How can management be supplied with reliable and accurate information?
- Is system security adequate?
- Can application programs be developed, maintained, and enhanced quickly and economically?
- How can data be processed in an efficient and timely manner?
- How can data integrity be insured?
- How can flexibility be maintained?
- What types of procedures need to be developed or modified to ensure that employee suggestions which affect collections of revenue are identified, given high priority, and implemented?

II. Response: Invalid Recommendation. It is the agency's position that resources will be more productively utilized identifying requirements and technologies to satisfy our needs for the future than conducting an intensive study of the requirements on which the existing STARS system is predicated.

Justification of Response: STARS is a complex, IMS data base management system, composed of a number of closely integrated modules. The system includes over 1,800 source modules, over 300 on-line screens, and over 70 data bases. The agency averages over 250,000 on-line transactions per day and provides support to a number of outside state agencies and localities, as well as in-house users. STARS was developed over a ten-year period, from 1980 - 1990, and significantly changed the manner in which many agency functions are performed. Requirements definition, systems design objectives, and general design documents were completed for each application system and were approved by multiple levels of agency user management to ensure that user requirements were identified and satisfied.

As sophisticated as STARS is, it was developed under certain restrictions which we now realize limit its effectiveness. These restrictions included primary users that were initially unaware of data processing capabilities and limitations, what they could expect STARS to do for them, and development time-frames and resource levels that were often less than adequate. In addition to development constraints, agency and user priorities, as well as legislation governing many of the taxes administered within STARS, have changed over the past ten years, consequently modifying the system requirements initially identified by users.

We are in agreement that based on the age of some of the component systems of STARS, as well as the other limitations discussed above, a number of areas within STARS require enhancement to be enhanced to better meet current user requirements. These areas have previously been identified by agency users and Information Systems staff, and some improvements have been made as funding has allowed. However, many of the suggested improvements have not been made because of resource limitations.

Emerging and state-of-the-art technologies, such as imaging, electronic funds transfer, electronic data interchange, and electronic filing, will address many of the areas that have been identified by agency users as having potential for significant productivity gains. These and other technologies currently being implemented by the Internal Revenue Service and other state tax agencies would allow future versions of STARS to more effectively serve all units within the agency, to interface more effectively with outside entities, to process data in a significantly streamlined manner, and to ensure the integrity of the data within STARS.

The agency must also begin to utilize CASE technology and relational data bases to satisfy future user needs. Doing so will allow for accurate, reliable and efficient user reporting, significantly reduced development and maintenance time, and a more rapid response to employee suggestions. In addition, the reengineering components of CASE tools could be used to significantly streamline the maintenance requirements of existing STARS systems.

Funding has been previously requested for each of the initiatives discussed above.

II. <u>Impact of Implementation</u>: Significant funding would be required to support a comprehensive review of STARS, whether conducted by DIT or utilizing in-house resources.

IV. <u>Legislation Required</u>: Appropriation required.

I. **<u>Recommendation 25</u>**: The Department of Taxation should fill the Deputy Commissioner position. The deputy commissioner should be responsible for understanding all aspects of the department's operation and be capable of administering the department in the Tax Commissioner's absence.

II. <u>Response</u>: Valid recommendation.

<u>Justification of Response</u>: This planned organizational change was never implemented due to significant budget cuts. Final candidates were selected for interviews when the process was stopped.

III. Impact of Implementation: The salary for this position is significant and until resources permit, the agency will not post the job. In the meantime, current management personnel will assist the Tax Commissioner.

IV. Legislation Required: Appropriation required.

I. **Recommendation 26**: The Department of Taxation should reorganize its operations to accommodate the filling of the Deputy Commissioner position, to reduce the number of assistant commissioners to two, and to address current organizational weaknesses. The reorganization should also reassign the audit and collection functions to ensure that two different divisions no longer have responsibility for both delinquent accounts and auditing taxpayers.

II. Response: Invalid recommendation. Already under review.

Justification of Response: This agency is currently working on an organizational plan with personnel from the Center for Public Service, University of Virginia that will give appropriate consideration to the recommendation. Our current functional organization may be superior to the IRS audit and collection style; however, it will be reviewed.

III. Impact of Implementation: There are no plans to implement this recommendation - only to consider it with many others.

IV. Legislation Required: No.

I. **Recommendation 27**: The Department of Taxation should review all currently established positions to ensure that work responsibilities are commensurate with the employees' abilities and time constraints.

II. Response: Valid Recommendation.

Justification of Response: During times of fiscal constraints and reduced resources, organizations strive to maximize utilization of all employees. Managers in the Department of Taxation are charged with assessing work loads and balancing assignments among employees. We have had many situations where personnel were temporarily assigned to meet heavy or changing work loads. Daily management decisions are made to ensure proper work coverage. It is difficult to say that all employees are being properly utilized all of the time, but certainly managers are monitoring work loads to ensure completion of assignments and to get the best performance from employees in all positions.

In the state's classification system, positions are not written around employees' abilities, but are written based on the job to be done. The department has prescribed work to be done. An annual review of all position descriptions is conducted for purposes of performance evaluation. Employees and supervisors certify that duties and responsibilities are current and accurate. If discrepancies are noted, corrections to the position descriptions are made.

The department recruits and hires or promotes the best people for the jobs to be done. It is expected that some individuals will be hired who have exceptional ability. As promotional opportunities become available, all employees are encouraged to apply for positions that would best utilize their qualifications. As new assignments develop, management tries to assign responsibilities based on abilities of current employees. As noted in our response to Recommendation 41, the department maintains a vigorous classification/compensation program to ensure that job duties and responsibilities outlined in position descriptions accurately reflect the work being performed.

As we are unaware of instances where employees are not working to full capacity, any information on this situation that could be provided by JLARC would be welcomed. This agency wishes to study this matter. Having some staff who are not challenged or busy while others have more than they can handle is clearly an ineffective use of staff and needs to be corrected. This definitely will be one area that will be reviewed as the Management Team proceeds with the agency reorganization.

For additional information on classification/compensation actions, please refer to the agency response to Recommendation 41.

III. Impact of Implementation: As noted above, this is currently being done.

IV. Legislation Required: No.

JLARC Note:

Staff in questionnaire and interview responses and our own reviews of workload data indicated that some tax department staff are not fully utilized while others are unable to complete all assigned work. Even if the annual performance evaluation were an appropriate time to review workload assignments, 42 percent or 80 of 190 questionnaire respondents indicated it had been more than a year since their last evaluation. Since department staff have indicated they are unaware of instances in which staff are not working to full capacity, another mechanism for determining staff utilization that is not related to performance evaluation may be advisable.

I. **Recommendation 28**: The Department of Taxation should limit the number of delinquent individual income tax accounts that are sent to the district offices. If individual income tax accounts accumulate, they should be handled by central office and additional delinquent business accounts should be sent to the district offices.

II. Response: Invalid recommendation. The department currently limits the volume of individual accounts assigned to district offices; however, the department disagrees with the inflexible process recommended by JLARC.

Justification of Response: All organizations require flexibility in dealing with short-term problematic areas and issues. Due to current fiscal constraints, this is particularly true of state agencies.

The department does not routinely assign a large volume of past due individual tax accounts to its district offices. Nonetheless, the JLARC recommendation would remove a great deal of the department's flexibility in collecting delinquent accounts.

The current inventory of individual income tax accounts in the district offices occurred as a result of an April, 1991, agreement between Field Services and Office Services divisional management. This was a short-term strategy to deal with backlogs in the central office Collections Section and will not have any long-term impact upon district offices.

A similar short-term strategy was adopted in October 1991, at the request of the department's Collections Task Force (consisting of all Field Services and Office Services collection supervisors), to maximize collections of large-dollar outstanding assessments. This strategy entails the transfer of current individual and business tax accounts totalling $1,000 or more to the district offices for immediate handling.

III. Impact of Implementation: Implementation would decrease the department's flexibility in dealing with short-term collection problems.

IV. Legislation Required: No.

I. **Recommendation 29**: The Department of Taxation should involve the district offices in its decision making regarding the assignment of audit and collection staff. The availability of office space and support staff and the revenue potential of the district offices should be considered when assigning audit and collection staff.

II. Response: Invalid Recommendation. Standard practice.

Justification of Response: District personnel are substantially involved in the department's decision-making processes, including decisions regarding the assignment of audit and collection staff. Over the past six years, meetings have been held on a regular basis with District Administrators, Audit Supervisors and Compliance Enforcement Supervisors for the express purpose of obtaining input, feedback, suggestions, and recommendations on the audit, collection, and general district operations.

In addition, working committees made up of district personnel and other agency staff have been utilized on a regular basis for the purpose of identifying, evaluating, and providing recommendations on district operations to include audit and collection activities. Data developed by the Integrated Audit Committee (consisting of district supervisors) was the basis for assigning the 60 additional auditors during the 1992 biennium. Average dollars assessed per auditor per year by region, total dealers, number of 8/83 dealers, percentage of 8/83 dealers to total dealers, and level of existing staff were criteria considered in assigning the auditors.

Revenue potential has been the primary factor for the assignment of compliance personnel; however, consideration is given to the availability of office space and support personnel.

III. Impact of Implementation: None.

IV. Legislation Required: No.

I. **Recommendation 30**: As part of the Department of Taxation's strategic planning process, the conditions of the district offices and the effect of those conditions on productivity should be examined. As part of this examination, the amount of floor space and the condition and availability of furniture and equipment should be reviewed. The department should determine whether it would be more cost effective to emphasize an office- or home-based approach within each district office in determining space, furniture, and equipment needs. Included within furniture needs should be a locking file cabinet for each home-based collections and audit employee. A furniture and equipment replacement schedule should also be developed for each district office.

II. Response: Valid Recommendation. The department already recognizes this need; however, there is no funding for implementation.

Justification of Response: As part of its strategic planning process, the department continually examines and assesses the conditions existing in the district offices. Such appraisals include determinations relative to the appropriate types of basing (office v. home), office space requirements, furniture and equipment needs, environmental interactions, and the ratio of support staff to field personnel. Shortfalls currently exist in all of these areas primarily because of department budget constraints and escalating costs associated with procurement.

While trying to maintain adequate work conditions in its district offices, the department has also had to maintain its central office facilities. The central office has encountered some of the same problems as the district offices.

When the department's eight district offices were established in the late 1960's, personnel authorizations, furniture and equipment levels, square footage allocations, modes of operations, etc., were adequate in order to achieve the desired goals. This situation continued through the early 1980's with only modest gains in field personnel authorizations and routine replacement/repair of furniture and equipment.

Recognizing an increased need for better planning and coordination as a result of anticipated growth in the 1980's, the department instituted various mechanisms to identify, inspect, evaluate and prioritize furniture and equipment needs. New and innovative ways were developed and implemented to offset increases in compliance staff allocations in locations where it was not economically feasible to increase office space. After examining the effectiveness of the home-based auditor program used in rural areas, the department determined that this type of program could also be effectively used in urban areas.

Thus, to offset increased staff in urban areas selected staff were permitted to operate from their homes and others were assigned to a centralized work station whereby employees work in the district office on predesignated, alternate days. Personnel assigned to these variant work arrangements were allocated appropriate equipment. Since audit personnel spend a majority of their time at a taxpayer's place of business auditing and have laptop computers with which to process their findings, they do not need to be in the office every day. These alternate work arrangements have enabled the department to accommodate additional staff without having to increase office space.

In addition, a committee consisting of Field Services personnel was established to address furniture and equipment repair and replacement or augmentations needs.

III. Impact of Implementation: Full implementation requires funding that will provide adequate equipment, furniture, and office space for office-based personnel, as well as adequate equipment and security devices for both home-based and centralized work station personnel. Total replacement cost for furniture and equipment is estimated to be $482,000. Increased space cost would range from $8.00 to $13.51 per square foot depending on the region of the state.

IV. Legislation Required: Appropriation required.

JLARC Note:

The department acknowledges that shortfalls currently exist in office space, equipment, furniture, and support staff. However, the department has provided no estimates of increased revenue collections that could result if these conditions were addressed and compliance staff productivity were improved. This estimate is needed to effectively evaluate the priority to give alternative replacement schedules. The tax department's cost estimate seems to include replacing practically all of the furniture and equipment in the district offices. It was not the intent of the JLARC staff recommendation to do this immediately.

I. **Recommendation 31**: The Department of Taxation should submit a preliminary staffing plan that links the implementation of additional compliance activities with the staff needed to carry out those activities. An estimate of any expected revenue increases or cost reductions should be included within the plan also. This staffing plan should be submitted for consideration prior to the conclusion of the 1992 General Assembly.

II. Response: Invalid Recommendation.

Justification of Response: This recommendation appears to be premised on the assumption that the department intends to request 60 additional compliance auditor positions in the fiscal year beginning July 1, 1992. The department, however, has no plans to request these positions. It will, instead, closely examine the impact the 60 compliance auditors which were added over the last two fiscal years have had on other areas within the agency. If additional staffing is necessary, it will be requested.

While the department has recognized the need to fill noncompliance positions needed to support the additional compliance personnel hired, it has been unable to do so because of budget constraints. Due to the requirement that compliance positions be held at a 98 percent fill rate, all budget cuts have been taken in noncompliance positions, including support and wage positions.

In addition, it is important to note that when legislation establishing new departmental programs is introduced before the General Assembly, legislative impact statements submitted by the department specify the costs of implementing the legislation, including any compliance and noncompliance positions, systems costs, other administrative costs, etc. However, these costs have not always been reflected in the department's final budget appropriation.

III. Impact of Implementation: None.

IV. Legislation Required: No.

JLARC Note:

It is unclear where the idea that this recommendation is "premised on the assumption that the department intends to request sixty additional auditor compliance positions" originated. The idea is not contained within the JLARC report. The JLARC report does note that additional compliance positions to collect tax assessments, support staff, planning staff, and computer programmers may be needed.

The legislative requirement that 98 percent of compliance positions be filled is predicated on the desire to maximize the number of compliance staff working to generate tax revenue for the State. Having compliance staff completing administrative, clerical, and taxpayer assistance duties disregards the intent of this requirement.

I. **Recommendation 32**: The Secretary of Finance should require the Department of Planning and Budget to complete a comprehensive evaluation of staffing needs and personnel practices within the Department of Taxation. In completing the evaluation, a close examination should be made of revenue-producing improvements, the proposed reorganization, variances in workload, the number of management staff, and DOT's personnel practices including hiring and promotion practices, job classification, affirmative action, and salary and benefits administration. This evaluation should be completed prior to the 1993 General Assembly session.

II. Response: Invalid recommendation. Need is not justified.

Justification of Response: A comprehensive evaluation of the staffing needs and personnel practices is not needed. The areas recommended to be studied are areas addressed on an ongoing basis by the agency's management team. There are no issues or significant problems identified by this study or any other study that would justify the scope or intent of this recommendation.

III. Impact of Implementation: Both agencies involved will incur significant costs to complete a comprehensive evaluation. This study would likely take a study team of 4 employees a year or more to complete. It is our opinion that the results would be of minimum benefits to the Secretary of Finance or Taxation.

IV. Legislation Required: Appropriation required.

I. **Recommendation 33**: As a function of its reorganization, the Department of Taxation should review the position description for each management position to ensure that the position and the management responsibilities are needed. The goal of this examination should be to reduce the number of layers of management and the actual management positions over time.

II. Response: Invalid recommendation. Standard practice.

Justification of Response: As referenced in the agency's response to Recommendation 41, the department is constantly reviewing positions. In a study of supervisor positions in the Office Services Division conducted in 1990, we were able to eliminate the use of the classification of State Tax Supervisor A by reorganizing the supervisory responsibilities within the Collections, Taxpayer Assistance and Compliance units. This division was able to provide the same level of service and properly manage each of the noted functions with one less layer of supervisors. This success does not by any means indicate that the same thing could be done in other areas of the agency, but is one illustration where the department was able to streamline the operation.

Reviews of position descriptions are continually conducted within the Department of Taxation to ensure that responsibilities are accurate and necessary. It is, however, difficult to review one management position without studying the impact of that position on the entire work unit and on the chain of command. JLARC notes that the maximum number of levels of management positions is eight in the agency and this should be reduced, but their own Alternative Organization for the Department of Taxation charted on page 112 increases this maximum number by one to create the Deputy Commissioner. This clearly seems inconsistent with this recommendation.

Another point of concern is the reference to span of control. The number of subordinates a position has under its supervision should not be used to conclude that the position may not be needed. Although a manager may only have one or two subordinates, there may be many other responsibilities assigned to that person that are unrelated to supervision. Even if the supervisory responsibilities are removed, the position may be needed to perform these other functions. JLARC notes that they did not conduct an extensive review of the management positions in the agency but instead based their conclusions from calculations of the number of management positions divided by the number of total positions. These calculations make no adjustment for technical responsibilities which require specialized experience, training and knowledge to perform the duties of the position.

Obviously, the pending reorganization will require that the Management Team review all functions within the agency. Levels and numbers of managers, spans of control and other factors will be considered in deciding the proper organization structure. The purpose of the reorganization will not necessarily be to reduce the number of managers, but to mold the organization into a more efficiently and effectively managed agency. If reductions in management staff appear feasible and do not restrict agency operations, then consideration will be given to reducing the number of managers.

III. Impact of Implementation: An ongoing evaluation is already being conducted. The use of State Tax Supervisor A classification in Office Services was eliminated in 1990.

IV. Legislation Required: No.

JLARC Note:

The tax department notes that a study of supervisor positions within the office services division resulted in the elimination of the use of State Tax Supervisor A positions and one management layer. A review of that study indicates that this was actually accomplished by reallocating five supervisor A positions (grade 10) to a higher supervisor senior position (grade 12) and reallocating the workload. This was not what JLARC staff were advocating in reducing the number of management layers and the actual number of management positions over time.

The purpose of filling the deputy commissioner position is not to decrease management layers but to provide for better management of the entire department. Management layers lower in the organization, particularly in areas in which a manager supervises one non-clerical staff member should be carefully examined.

I. **Recommendation 34**: The Department of Taxation should develop a strategic planning process that takes an integrated, comprehensive approach to planning for the agency. As part of this process a written strategic plan should be developed and continually updated. The plan should consider future needs and changes that are expected to have a significant impact on agency operations and include input from department staff. The plan should include but not be limited to assessing the estimated tax gap and strategies to close it, collections strategies related to converting to accurate withholding, potential tax policy changes, automation and technological advances, staffing needs, physical plant requirements, management needs, and environmental changes that are outside the agency. The strategic plan should be submitted to the Secretary of Finance and the House Finance and Senate Finance committees.

II. Response: Invalid Recommendation. The plan has already been developed.

Justification of Response: The department has a documented strategic planning process which directly correlates with the biennium budget cycle. The document is updated regularly. The steps followed in our planning process are outlined on pages 4 - 6 of the current strategic planning document.

There are many appropriate styles and processes that can be followed when planning. The department feels this is effective for our organization. The strategic plan was developed by agency management with assistance and review by the Center for Public Services at the University of Virginia and JLARC commends our efforts on page 130 of the draft audit document.

Future needs and changes are included and individual input from department employees is recognized as a formal step in the planning process. The majority of the items that JLARC recommended for inclusion in the strategic plan are addressed in plan or are included in the strategies and resource allocations in our Financial Proposal.

The strategic planning document is submitted to the Secretary of Finance and the Department of Planning and Budget annually and reported on quarterly.

III. Impact of Implementation: No impact. Recommendation previously implemented.

IV. Legislation Required: No.

> JLARC Note:
>
> As noted in the JLARC report, the tax department's long-range planning is too limited in scope and gives insufficient attention to compliance functions and the resources needed to maximize revenue collections. Considering that 60 percent of the department's staff are considered to be compliance positions, it is surprising that the department's Strategic Business Plan contains little regarding plans for future compliance operations. Areas noted in the JLARC report as being left out of the department's plan include: an estimate of revenue that is not collected due to underreporting or underremittance of taxes, strategies for closing the tax gap, and the effect that accurate withholding may have on voluntary compliance. An examination of trends in voluntary compliance and ways to increase revenue collection could assist the department in successfully arguing for additional staff and funding.

I. **Recommendation 35**: Responsibility for the development, monitoring and revision of the Department's strategic plan should be supervised by the deputy commissioner and assigned to staff whose primary function is to work with department management on strategic planning.

II. Response: Invalid recommendation. Resources for recommendation of low priority, nonessential.

Justification of Response: The responsibility of the agency's strategic plan currently rests with the management team. The agency commits staff resources to support the strategic planning process it has adopted. In a period of severe budgetary constraints, additional staff resources for this function are not needed or justified. For example, if the agency was authorized to fill 15 new positions, probably none would be assigned to this function at this point in time.

III. Impact of Implementation: Minimum staff of two people required to support function. Agency costs would be at least $75,000 with revenue losses from not hiring compliance or compliance support resources.

IV. Legislation Required: Appropriation required.

I. **Recommendation 36**: The Department of Taxation should develop an equipment replacement schedule that includes projected costs, cost savings, and any effects on efficiency or effectiveness that not replacing the equipment might have.

II. Response: Valid Recommendation. No funding for implementation.

Justification of Response: The department agrees that we have sophisticated machinery and equipment, that we do not have a detailed equipment replacement schedule and that not replacing equipment could hinder productivity. However, we do not agree that having such a schedule would allow the department to have replacement costs routinely included in the agency's budget. It has been our experience that this item has been an area where the Department of Planning and Budget has looked first to remove funding when dollars are short. This agency, like most general funded agencies, has been level funded since the early 1980's except for new initiatives.

The department has followed the philosophy that the individual division manager should make the case for the needed equipment and the highest such priority need will be funded out of the agency's level funded budget when the need is the highest and when funds can be identified. The highest priority equipment has been replaced or purchased or is scheduled to be purchased in the following amounts over the three biennia despite the level funding constraints we were working under:

1986-88	$ 1,305,014
1988-90	1,043,686
1990-92	1,037,176.

The agency does not agree with the JLARC conclusion that having the plan will categorically allow that funds will be available to purchase needed new equipment. The agency further believes that it would take considerable staff hours to produce the suggested equipment replacement plan and many hours to maintain it with ever changing prices and technologies. Staff time is simply not available to develop such a plan. If additional staff time were suddenly made available, this would not be the highest priority for its use.

III. Impact of Implementation: Essentially the development of this plan would probably take at least two very knowledgeable people full-time for a period of one year to understand the uses of and to analyze all the equipment we have, to review the replacement costs, and to investigate the potential new technologies as they could be applied to the department's activities. Funding for such staff is simply not expected to be available.

IV. Legislation Required: Appropriation required.

I. **Recommendation 37**: The Department of Taxation should follow the Auditor of Public Accounts' recommendation to review the access that all employees have to STARS screens and limit that access to screens needed to complete routine functions. The department also needs to carefully review the STARS system and its current functions to determine what procedures can be added or changed to increase the security of the system and decrease the potential for fraud and or other illegal activities.

II. Response: APA Review of Stars - Invalid recommendation. Procedures are already being performed.

Justification of Response: Procedures are currently in place to monitor access provided to users. These procedures provide for frequent/routine review of access privileges for employees.

Response: Review of STARS Security - Invalid recommendation. The security system is a proactive one that continually monitors the functioning of the STARS system and institutes changes where deemed beneficial in increasing security.

Justification of Response: Examples of the continual review of our security system are:

(1) revision of policy on Confidentiality to impose stricter penalties for inappropriate use of STARS to obtain taxpayer information;

(2) modification of security system to log ALL accesses.

(3) disciplinary actions taken within the Code Of Conduct to deal with security violations.

III. Impact of Implementation: Current procedures provide adequate security through review of access at supervisory level to insure that screens are granted to employees based on job requirements.

The Agency's current practices incorporate the continual review of security to the STARS system.

IV. Legislation Required: No.

JLARC Note:

According to the APA, employee access to screens not necessary for their daily job functions continues to exist. Further, the department's review procedures, outlined above in their response, are either ineffective, too new to have made a positive impact, or do not exist.

I. **Recommendation 38**: The Department of Taxation should work with the Office of the Attorney General and the Department of Personnel and Training to establish policies and procedures for completing criminal records checks, credit checks, and checks to determine whether federal and state income taxes are paid. To the extent possible, these checks should be completed for current and potential employees.

II. Response: Valid Recommendation.

Justification of Response: Currently, the Department of Taxation is reviewing data for the development of a policy which would require detailed background checks, including the review of financial, criminal, and delinquent tax histories for new employees. Once completed, the policy must be reviewed by the Office of the Attorney General and the Department of Personnel and Training. As other agencies have similar policies in place, we should expect our policy to be approved by these agencies. We anticipate implementing this policy after the appropriate approvals have been obtained.

III. Impact of Implementation: The inclusion of current employees will create problems as to how to discipline violators of the policy. Although it would be easy to exclude applicants from consideration, current employees would have to be disciplined under the Employee Standards of Conduct and Performance. This would require the development of offenses and disciplinary actions under these standards. Additionally, an ongoing review of current employees' credit histories, criminal records and filing of federal and state taxes would be necessary. Considerable staff time and expense would be incurred if continual checks on employees were required.

IV. Legislation Required: Appropriation required.

I. **Recommendation 39**: The General Assembly may wish to amend the Code of Virginia to require the Department of Taxation to complete background checks on its employees.

II. Response: Valid Recommendation.

Justification of Response: As stated in our response to Recommendation 38, the department plans to proceed with the development of a policy which would require background checks on new employees. The placing of this requirement in the Code of Virginia would give us statutory authority and reinforce the need for such checks. Although we feel that we have authority to establish a background check policy, the General Assembly mandate would clarify any issues that could arise by requiring the Department of Taxation to conduct thorough background checks for all employees.

The issue of current employees and the General Assembly's direction would also be welcomed as there may be issues concerning those present employees who would not now pass the new background check, but are currently adequately performing the duties of their position.

III. Impact of Implementation: Refer to Impact Statement on Recommendation 38. The same concerns would apply to a General Assembly mandate and should be considered if the Code of Virginia is revised.

IV. Legislation Required: Legislation Required.

Appropriation required.

I. **Recommendation 40**: The Secretary of Finance should ensure that the Department of Taxation implements recommendations made by other agencies.

II. Response: Invalid recommendation. Process already in place.

Justification of Response: The agency has for over 10 years submitted quarterly reports to the Secretary of Finance. These reports include the types of reporting issues identified in the recommendation. In addition, not all recommendations made by other agencies are valid. Our responses to these types of recommendations are formally made. For instance on Page 140 and 161 of this report, JLARC makes "off the wall" comments about the agency's internal audit function. These are the JLARC staff's own interpretations of someone else's report. Nowhere in the report of this function is the conclusion drawn that our Internal Audit function is "ineffective". We have addressed all comments made on the function and have work plans to correct those deficiencies that are valid.

III. Impact of Implementation: None.

IV. Legislation Required: No.

JLARC Note:

Submission of quarterly reports to the Secretary of Finance has not ensured that the tax department has implemented the recommendations made by other oversight groups. The Department of the State Internal Auditor, in its 1991 review, concluded that "insufficient action was taken [by the tax department] to correct the deficiencies" that had been identified in its 1988 report. The tax department's assertion that "not all recommendations made by other agencies are valid" is consistent with the department's expressed opinion about the recommendations made within this report and its past failure to implement recommendations by oversight agencies.

JLARC's characterization that the tax department's internal audit unit has been described as ineffective is valid. The State Internal Auditor in his letter to Commissioner Forst on October 4, 1991 stated, "deficiencies in practice were found that were considered so significant as to seriously impair or prohibit the program from carrying out its responsibilities." The letter also states that the audit "program does not comply with the provisions of the Standards for the review period."

I. **Recommendation 41**: The Department of Taxation should identify and implement approaches to address employee concerns about morale, salaries, communication, management and leadership. Having large percentages of staff reporting negative responses may indicate that these problems are impairing effectiveness. Among the approaches considered, should be the techniques proposed by W. Edward Deming which relate to quality control and employee involvement.

II. Response: Invalid Recommendation. The Management Team of the Department of Taxation is concerned about each of the areas outlined in this recommendation and has been actively addressing these concerns.

Justification of Response: Each of these areas is addressed separately as follows:

EMPLOYEE MORALE: Due to the current budget situation in state government, most agencies are having to consider the adverse impact that no salary increases and higher employee costs for benefits have on employee morale. In general, employee morale is low during times of budget constraints and limited resources. "Doing more with less" is an overused phrase that is good in theory, but in reality places tremendous stress on the work force. As many management studies have shown, the employee's work environment and working conditions directly contribute to morale.

Further, it should be noted that the survey results show conflicting responses in the area of morale. When questioned about agency morale the response was listed as good by only 30 percent of the staff. However, when asked to rate "their own morale" 81 percent rated it excellent, good or fair. Only 19 percent rated it as poor.

The agency Management Team has been exploring measures that can be taken to positively affect employee morale. One new benefit that will be implemented on a test basis is the allowance of alternate work schedules. A policy has been written that will allow divisions to determine which optional work schedules can be provided to employees, including earlier starting times, later starting times, four day and/or four and one-half day workweeks. This policy has been approved by the Management Team and has been forwarded to the Department of Personnel and Training (DPT) for their review and approval.

Consideration is also being given to options for recognizing employees. The agency service award program is under review and other options are being considered that may be more appropriate to recognize high performers and/or long term employees. Also, we have an active wellness program for all employees which offers many activities such as brown bag seminars, cholesterol screenings, diet programs, blood pressure screenings, aerobics, etc.

These illustrations represent just a few of the actions that are being taken to address employee morale and improve the quality of work life.

SALARIES: Throughout the past five years the Department of Taxation has taken a very aggressive approach to ensuring that employees are being properly compensated for the work performed. In 1987, a major compensation study was initiated which included 352 positions. This study was very comprehensive and lasted over two years. We were very successful in convincing the Department of Personnel and Training that many of our employees were not properly compensated for the work being performed. Approval was secured for salary increases for approximately 250 employees. During this study the need was recognized for the establishment of a Classification and Compensation Supervisor to plan for the continual review of agency positions. This position was filled in 1988 and has actively been reviewing positions to ensure that adequate compensation is assigned to positions based on duties and responsibilities. Since 1986, over 530 employees have received salary increases due to classification/compensation reviews and/or studies.

As previously mentioned in this report, some employee discontent is expected in times of budget constraints, limited resources and lack of salary increases. Additionally, when the department's compensation study was completed, all of our salary requests were not approved by the Department of Personnel and Training. Obviously, those employees whose positions were not reallocated or salary levels were not regraded were very disappointed and probably are still concerned about their compensation. Although the department presented a good argument for all positions in the study to receive salary increases, we did not receive approval for some of our requests. Where appropriate, the agency appealed DPT's disapprovals of our requests, but to little avail.

The management of Taxation spent an enormous amount of time communicating information to employees about the study before our requests were sent to DPT, during their review and after the final decision was made. The Tax Commissioner, Human Resource Manager and other managers held group meetings with employees to explain the study and information was routinely communicated in the agency newsletter, employee bulletins and staff meetings. It is, however, understandable that employees become very upset when some employees receive salary increases while others do not. These actions are not soon forgotten and may be part of the reason that the recommendation reflected employee concern about salaries. The management of this agency has always been concerned about proper compensation for employees and where justified, has taken action to increase salaries. This will continue to be a high priority for the Management Team.

COMMUNICATION: Communication within an organization is always a concern. Taxation is no different from other organizations in that we recognize problems with communication and are working with employees and managers to ensure that information is disseminated promptly and accurately and that employees are being given the opportunity to provide input from the bottom up. This will be an issue that will be addressed as the Management Team continues the process of reorganizing the agency. Delegations with authority and accountability will be major factors in redesigning the agency structure to become more efficient and effective with fewer resources.

MANAGEMENT and LEADERSHIP: In 1989, the Management Team determined that the agency was not properly preparing employees to assume greater responsibilities, particularly at the supervisory/management levels. Accordingly, the Employee Relations Office was asked to develop a Management Development Program for executives, managers and supervisors. In 1990, this program was implemented and actually went one step further in the development of employees and included employees who are functioning as work leaders. The purpose of the program is to encourage leaders, supervisors and managers not only to improve in their ability to function in their current positions, but to move beyond the position's responsibilities. In the first year of the program, 222 employees were identified as being eligible to participate. Overall attendance for the first year was 796, which on the average indicates that each participant attended between 3 and 4 sessions. It is our understanding that this information was made available to the JLARC staff.

Employees of the department actively participate in state sponsored programs including the Virginia Executive Institute, Commonwealth Management Institute and Virginia Supervisors Institute. Additionally, Management Team members and other managers will attend or have attended the Federal Executive Institute in Charlottesville. Currently, the Management Team is participating in team building sessions with the assistance of consultants from the University of Virginia with the goal of building an effective team to take the agency into the future beginning with the reorganization plan that is being developed.

Another Management Team decision which should improve quality of work is the approval of an agency Technical Training Plan. It was recognized that agency employees must maintain a good working knowledge of technical information, including various tax laws, rules and regulations as well as STARS (State Tax Accounting and Reporting System). In 1992, assuming funds continue to be available, the agency will begin a long term, structured training program to ensure that employees are adequately trained in technical areas.

As mentioned above, the reorganization will shift some delegations and authority and will emphasize the need for all employees to be accountable for quality as well as quantity of production. Consideration will be given to ways to improve quality, including methods to incorporate employee input into the process. Unless very severe budget cuts are forthcoming, management intends to continue an aggressive training program. Management techniques, such as total quality management proposed by W. Edward Deming, will certainly be reviewed to determine if implementation within the department would be practical and effective. Obviously, during and after the reorganization, the Management Team will be in a better position to decide the most feasible approach to improving quality and to increase employee involvement. This issue remains a high priority for the Management Team.

III. Impact of Implementation: Total quality management approaches like those proposed by W. Edward Deming take several years of training for both management and employees.

IV. Legislation Required: No.

I. **Recommendation 42**: The Department of Taxation should ensure that the determination of doubtful collectibility is properly substantiated prior to accepting an offer in compromise as required by § 58.1-105 of the Code of Virginia. File documentation should always include a financial statement regarding the taxpayer.

II. Response: Valid Recommendation.

Justification of Response: The department agrees that proper substantiation should be made prior to accepting an offer in compromise. Guidelines for determining what information should be obtained prior to accepting an offer in compromise are contained in TAX's Approved Operating Policies and Rules.

The type and amount of documentation varies based on each specific situation and the amount of tax. Each case must be decided based on the explanation and evidence presented or otherwise obtainable. A financial statement may not be required when the other documentation is sufficient to support a finding of doubtful collectibility. However, the reason for the acceptance of offers in compromise and supporting documentation should be, and is in the majority of cases, preserved among the records of the department. Some documentation has been filed with the abatement action rather than with the official offer file.

The department's Information Systems Division is in the process of developing more detailed procedures for the handling of offers in compromise involving doubtful collectibility. These procedures should ensure that the required documentation is maintained with the official offer file prior to the case being closed.

III. Impact of Recommendation: None.

IV. Legislation Required: No.

JLARC Note:

JLARC staff went on-site to verify the findings of our analysis of a random sample of documentation of offers in compromise. While the department may be correct in saying that supporting documentation is "preserved among the records of the department" such information is not readily accessible. It took four tax department staff more than two hours to locate information on one of our random sample files. After two hours, the tax department staff noted that no additional documentation other than that reviewed previously by JLARC staff was available.

I. **Recommendation 43**: The Secretary of Finance should ensure that the Department of Taxation establishes formal written criteria for accepting offers in compromise made due to doubtful collectibility. Such criteria should take into account the taxpayer's complete financial situation.

II. Response: Invalid Recommendation. Criteria already established; not appropriate for Secretary of Finance to review.

Justification of Response: Guidelines for offers in compromise are contained in the department's Approved Operating Policies and Rules (see Recommendation 42). Although the procedures do not delineate the specific criteria for acceptance or rejection of offers in compromise based on doubtful collectibility, they do require that a taxpayer's financial condition, prior collection efforts and further potential collection actions be considered. In most cases, a financial statement is obtained from the taxpayer.

The department's Information Systems Division is in the process of drafting procedures on offers in compromise involving doubtful collectibility.

III. Impact of Implementation: None. Duplication of existing procedures.

IV. Legislation Required: No.

I. **Recommendation 44**: The Department of Taxation should take immediate steps to ensure that complete and accurate documentation is provided for all offers of compromise and tax abatements involving reasons that must be documented. Documentation requirements for both hard copy information in files and computerized data on STARS should be carefully reviewed.

II. Response: Invalid recommendation. Offer in compromise procedures are currently being finalized and abatement procedures already exist.

Justification of Response: The JLARC study, previous Auditor of Public Accounts studies, and two studies by the department's internal auditor have identified no improper abatements. Questions have focused solely on the consistency of documentation.

The department's Information Systems Division is drafting procedures on offers in compromise involving doubtful collectibility. A part of these procedures will address the documentation requirements and the necessity to ensure all documentation is maintained with the official file maintained on the offer. JLARC has not identified any documentation problems involving offers in compromise on issues of law or appeals to the Tax Commissioner under Va. Code § 58.1-1821 (see response to Recommendation 46).

Abatement guidelines are contained in the department's Approved Operating Policies and Rules. Additionally, the STARS Operator's Manual (Exhibit Book) lists the abatement reason codes and identifies those codes which require documentation.

As pointed out by JLARC, a study conducted by the department's internal auditor recognized that incorrect reason codes were being assigned to abatements in some instances. However, JLARC failed to point out that an Abatement Quality Control Committee was established in FY 91 to periodically conduct a quality review sample of abatements (proper documentation, proper reason code, etc.). To date, the committee's results which are reported to the Director of the Office Services Division, have not reflected any significant problems.

III. Impact of Implementation: Minimal as procedures are already in place or are being developed.

IV. Legislation Required: No.

I. **Recommendation 45**: The Department of Taxation should establish written requirements for the documentation of audit procedures. These audit procedures should include guidelines for determining how audit samples are selected; for determining how complete taxpayer records are; for completing work papers that clearly support audit objectives, procedures, and findings; and for requiring supervisory review of audit documentation and conclusions.

II. Response: Invalid recommendation. Written procedures are already in place; all audits currently must be reviewed and approved by the senior auditor (audit team leader) and/or audit supervisor prior to assessment.

Justification of Response: Written requirements for the documentation of audit procedures already exist (see the department's Audit Manual and Sales and Use Tax Audit Program User's Guide). The Audit Manual is current, having been revised 6 times in the last 12 years, and specifically addresses each area of concern identified by JLARC. Each of the department's auditors has been provided a copy of the Audit Manual on diskette and hard copies of the Audit Manual and User's Guide are contained in each district office.

The concerns expressed by the Auditor of Public Accounts appear to reflect the esoteric differences between internal audit work papers and tax audit work papers. The objective of tax work papers is merely to identify items of income or property that may have improperly escaped taxation. To the extent that the auditor and the taxpayer can readily identify untaxed items, the standard for documentation clearly has been met. Further, as noted in a December 1991 article in Internal Auditor ("Enough Is Enough: When Does "Complete Work paper Documentation" Become Overkill?") co-authored by former Virginia Auditor of Public Accounts Charles K. Trible, "given finite audit resources, time spent in excessive documentation is time not spent in additional auditing."

Indicative of these conclusions, the department has received no complaints from either the Virginia Bar Association, the Virginia State Bar, or the Virginia Association of Certified Public Accountants as to the adequacy of audit documentation.

Due to frequent taxpayer questions, the department is currently in the process of developing a new sales and use tax regulation on audit sampling. This regulation will give taxpayers guidance on the questions most frequently asked in terms of sampling and what information auditors must have in selecting an appropriate sample period. The department informally advised the tax committees of the state bar and CPA associations of this project in October 1991 and plans to adopt a final regulation by December 1992.

III. Impact of Implementation: None, procedures are already in place.

IV. Legislation Required: No.

JLARC Note:

Again, the manual is very general in nature and therefore inadequate. Further, based on the APA review of the audits, the general procedures outlined in the manual were not applied consistently. Therefore, it appears that more specific guidance is necessary to correct the deficiencies noted in the report.

I. **Recommendation 46**: The General Assembly may wish to revise § 58.1-105 of the Code of Virginia to specify that summarized documentation, of downward adjustments by any means of more than 25 percent on assessments of more than $200,000, is to be submitted by the tax commissioner on a quarterly basis to the Secretary of Finance and to any oversight entity the General Assembly creates in response to alternatives presented in the next section of this chapter.

II. Response: Invalid Recommendation. Creates an additional reporting requirement; same results could be achieved by other, less intrusive, means (see also, response to Recommendation 47).

Justification of Response: This recommendation would create an additional reporting requirement, which may be of limited value.

The JLARC study, previous Auditor of Public Accounts studies, and two studies by the department's internal auditor have identified no improper abatements.

On large assessments specifically (page 158 of the study), JLARC infers that abatement documentation is generally lacking. However, this inference is not supportable. In actuality:

(1) Case files with substantial documentation are available on all appeals to the Tax Commissioner under Va. Code § 58.1-1821 (many of which are settled under § 58.1-105) and offers in compromise involving issues of law (doubtful liability).

(2) The Tax Commissioner's final determination on every appeal is already published (with only the taxpayer's name and identifying information deleted) pursuant to Va. Code § 58.1-204.

(3) After a sample of 100 appeal files and 58 offers in compromise involving issues of law, JLARC identified no specific instances in which documentation was insufficient.

(4) Of the 30 large assessments identified on page 158, 2 were paid in full and were not appealed, 10 were initially upheld on technical review with no change in the assessment, 8 remain in the administrative appeals process on substantive issues of state and/or federal law, 2 are currently in litigation after having been upheld in the administrative appeals process.

All downward adjustments result from technical review of an assessment (consistency with law, regulations, published policy, established audit procedures, etc.) OR a determination that the entire assessment is not collectible.

Further, a system of checks and balances already exists, downward adjustments of any size resulting from appeals and offers in compromise go through a minimum of a 4-step review process, culminating in approval by the Tax Commissioner.

There is little or no incentive for the department to adjust assessments downward without compelling evidence to support such an action.

III. Impact of Implementation: Creates an additional reporting requirement.

Review of downward adjustments by executive and/or legislative branch officials may raise concerns among the public as to the objectivity of the administrative appeals process. Similarly, such a reporting process may unintentionally compromise the confidentiality of taxpayer information.

IV. Legislation Required: No.

I. **Recommendation 47**: The General Assembly may wish to require the Auditor of Public Accounts as part of its annual review of the Department of Taxation to review the documentation for these downward adjustments of more than 25 percent on assessments of more than $200,000.

II. Response: Invalid Recommendation. The Auditor of Public Accounts already has the authority to review assessments, adjustments, and a wide variety of other departmental actions.

Justification of Response: The Auditor of Public Accounts already possesses authority to review information on any downward adjustment of a tax assessment. The Department of Taxation's own Internal Audit Division has also conducted two studies on this issue.

The study provides no evidence of missing or questionable information on large assessment adjustments. The department feels that its documentation standards for assessment adjustments are quite high and have been predicated, in part, on meeting a standard which would be acceptable in the event of audit by the APA or any other body.

While the department would not object to an APA review of assessment adjustments, it does object to the unsupported inference that these adjustments are not or may not be supportable.

III. Impact of Implementation: Minimal.

IV. Legislation Required: No.

I. **Recommendation 48**: The General Assembly may wish to further examine options for additional external oversight of the Department of Taxation. At a minimum, any oversight entity established should review the methodology for estimating the State tax gap, procedures for closing the tax gap, significant policy or procedural changes that are likely to affect tax revenue, and procedures instituted to prevent fraud of misconduct.

II. Response: Invalid Recommendation.

Justification of Response: There is no apparent justification within the report for establishment of a broad external oversight entity, an approach which would be unique among state agencies. (Where other oversight entities exist, they are typically targeted towards a discreet industry, profession or client base.)

As the report acknowledges, the State Corporation Commission and Industrial Commission operate to provide oversight to otherwise independent agencies. The same is true of the Lottery Board. The Tax Commissioner is appointed by the Governor and confirmed by the General Assembly, firmly establishing widespread accountability to both. The actions of the department are viewed and reviewed on a daily basis by local officials, legislators, the executive branch, and taxpayers, none of whom have been hesitant to hold the department accountable for its actions. The House and Senate Finance Committees may not be formally charged with oversight as at the federal level, but there is little question that legislative oversight in Virginia exists and is accorded great weight.

A 1980 legislative study (HD 30), including representatives from the Virginia Bar and CPA Society, reviewed the policy processes used by the department. As a result of this study, legislation was enacted requiring the use of the Administrative Process Act for promulgating all regulations and requiring that all rulings of the tax commissioner and other similar documents be published regularly. The department complies with these requirements, and as a result all policy documents are subjected to a level of public scrutiny exceeding that accorded most other agencies' actions. Within this context, it is worth noting that the department's published guidelines for ensuring public participation in the regulation development process have served as a model for many other agencies. In short, the department was on the leading edge of public accountability for its actions.

Most importantly, the 1980 study suggested the creation of a Board of Tax Appeals. However, the purpose of such a board was to provide an expeditious method for appeal of assessments without payment of the tax and was not targeted towards oversight, improved revenue production or any of the other objectives suggested by JLARC. This provision was considered, but not enacted by the General Assembly. (Interestingly, a tax commission administered Virginia taxes until 1927 when it was replaced with a Department of Taxation and a Tax Commissioner to improve efficiency.)

We have formal and informal working relationships with the Virginia Bar Association and CPA Society state tax committees and use this relationship extensively to solicit suggestions on forms revisions and to review policy proposals. In fact, this department is one of the most visible in terms of its contacts with client groups.

In summary, we do not argue that oversight is not essential. Rather we would assert that the degree of oversight and accountability to which we are subjected by virtue of our impact on virtually every citizen in the state is far greater than that of any other state agency and does not need artificial expansion.

III. Impact of Implementation: Contingent upon degree of oversight adopted.

IV. Legislation Required: Legislation required.
Appropriation required.

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