WEST VIRGINIA LEGISLATIVE AUDITOR

PERFORMANCE EVALUATION & RESEARCH DIVISION

Full Performance Evaluation

Department of Revenue

The State Is Losing Millions in Tax Revenue Because the Tax Department Does Not Use the Full Extent of Its Enforcement Authority

May 2006
PE 06-04-377

JOINT COMMITTEE ON GOVERNMENT ORGANIZATION

Senate

Edwin J. Bowman
Chair

Billy Wayne Bailey, Jr.
Vice Chair

Walt Helmick

Donna J. Boley

Sarah M. Minear

Citizen Members

Dwight Calhoun

John Canfield

James Willison

W. Joseph McCoy

(Vacancy)

House Of Delegates

J.D. Beane
Chair

Timothy R. Ennis
Vice Chair

Joe Talbott

Craig P. Blair

Otis Leggett

Scott G. Varner, Ex Officio Non-Voting Member

OFFICE OF THE LEGISLATIVE AUDITOR

Aaron Allred
Legislative Auditor

John Sylvia
Director

Alysia Miller
Research Analyst

Performance Evaluation and Research Division
Building 1, Room W-314
State Capitol Complex
Charleston, West Virginia 25305
(304) 347-4890

WEST VIRGINIA LEGISLATURE

Performance Evaluation and Research Division

Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610
(304) 347-4890
(304) 347-4939 FAX

John Sylvia
Director

May 21, 2006

The Honorable Edwin J. Bowman
State Senate
129 West Circle Drive
Weirton, West Virginia 26062

The Honorable J.D. Beane
House of Delegates
Building 1, Room E-213
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0470

Dear Chairs:

Pursuant to the West Virginia Sunset Law, we are transmitting a Full Performance Evaluation of the Department of Revenue, which will be presented to the Joint Committee on Government Operations on Sunday, May 21, 2006. The issue covered herein is "The State Is Losing Millions in Tax Revenue Because the Tax Department Does Not Use the Full Extent of Its Enforcement Authority."

We transmitted a draft copy of the report to the Department of Revenue on May 1, 2006. We held an exit conference with the agency on May 16, 2006. We received the agency response on May 18, 2006.

Let me know if you have any questions.

Sincerely,

John Sylvia

John Sylvia

JS/wsc

Joint Committee on Government and Finance

Contents

ISSUE 1: The State Is Losing Millions in Tax Revenue Because the Tax Department Does Not Use the Full Extent of Its Enforcement Authority.

The Legislative Auditor observed that the State Tax Department rarely exercised its statutory authority under §11-12-5 to suspend, cancel, or refuse to renew Business Registration Certificates (business licenses) as an enforcement tool for collecting delinquent tax liabilities. It is not uncommon for the Tax Department to renew business licenses for delinquent businesses that have active liens or warrants for unpaid taxes, that have not filed tax returns for several months, or that owe thousands of dollars in business taxes. The Legislative Auditor's concern is that by not using the full extent of its enforcement authority to collect tax liabilities, the Tax Department is allowing businesses to incur larger unpaid tax liabilities, resulting in the State losing more revenue. While the Business Registration Division may refuse the issuance of a business license based on default workers' compensation or unemployment compensation premiums, it does not refuse renewal for its own taxes.

The Legislative Auditor observed that the State Tax Department rarely exercised its statutory authority under §11-12-5 to suspend, cancel, or refuse to renew Business Registration Certificates (business licenses) as an enforcement tool for collecting delinquent tax liabilities.

The philosophy of the Tax Department is that if it refuses to renew a business license based on a business' delinquent tax liability, it will not collect the tax liability because of the business' defunct status. **The belief that threatening revocation will result in closing a business and collecting no revenue is born from a long practice of allowing companies to accrue large unpaid tax liabilities that are difficult to impossible to pay.** The Tax Department must intervene sooner to avoid unmanageable delinquencies that will result in no collection of revenue when it informs companies of revocations or the refusal to renew business licenses. The success of revoking business licenses under workers' compensation shows that this is the strongest enforcement tool the Tax Department has. The Legislative Auditor recommends that the Tax Department exercise this authority in order to minimize the loss of tax revenue.

While the Business Registration Division may refuse the issuance of a business license based on default workers' compensation or unemployment compensation premiums, it does not refuse renewal for its own taxes.

Recommendations

1. *The Legislative Auditor recommends that the Department of Tax and Revenue utilize the authority granted in §11-12-5 of the West Virginia Code as an enforcement tool.*

2. *The Legislative Auditor recommends that the Department of Tax and Revenue promulgate rules for applying §11-12-5 of the West*

Virginia Code.

3. *The Legislative Auditor recommends that the Department of Tax and Revenue establish policy and procedures to make renewal of business registration certificates contingent upon if a company's account is in good standing with the Department.*

4. *The Legislative Auditor recommends that the Tax Department discontinue the practice of allowing payment plans to be established at regional offices and have all payment plans centralized.*

Review Objective, Scope and Methodology

The West Virginia Sunset Law, Chapter 4 article 10, requires and authorizes the Legislative Auditor to conduct a Full Performance Evaluation of the Department of Revenue. The Department of Revenue oversees the State Tax Department, which is responsible for the administration and enforcement of the State's tax laws as well as equitably assessing and collecting all taxes created by the West Virginia code.

Objective

The objective of this review is to determine if the efforts of the Compliance Division to collect delinquent taxes can be enhanced by invoking the Tax Department's statutory authority to revoke or deny the renewal of business registration certificates of delinquent taxpayers.

Scope

This evaluation covers the period from the year 2001 through January 2006. The scope of this review concentrated primarily on the Compliance Division. A limited review was conducted in the Business Registration Office which included inquiring about the procedures followed when granting or revoking a business registration certificate, inquiry as to the number of business registration certificates revoked each year, and the reasons for revocation.

Methodology

The Workers' Compensation Commission provided the Legislative Auditor's Office with two lists totaling 3,759 policyholders who were notified that their business registration certificates would be revoked as a result of defaulted workers' compensation policy premiums. Policyholders were grouped by their action taken after receiving a notice of intended revocation. A third list containing 631 policyholders who did not respond and subsequently whose licenses were revoked was obtained from the business registration office. A sample, randomly selected from each list, was analyzed to determine the company's account status with the Tax Department. Business registration renewal dates were compared to active statements, assessments, liens, and warrants document dates in order to determine if business registrations were being renewed while taxpayers were in arrears. In addition, the accounts that were renewed while owing tax liabilities were reviewed to find out if payment plans had been set up before renewal occurred. Every aspect of this review complied with General Accepted Government Auditing Standards (GAGAS).

Issue 1

The State Is Losing Millions in Tax Revenue Because the Tax Department Does Not Use the Full Extent of Its Enforcement Authority.

The Legislative Auditor finds that a primary reason for a large amount of the unpaid business tax liabilities is that the Tax Department does not adequately minimize the amount of debt that delinquent businesses accrue, particularly trust fund taxes such as sales and wage withholding taxes.

The Legislative Auditor found that the Tax Department routinely renews business licenses for delinquent companies that have liens and warrants filed against them, that have not filed tax returns for several tax periods, and that owe thousands of dollars and are not on payment plans.

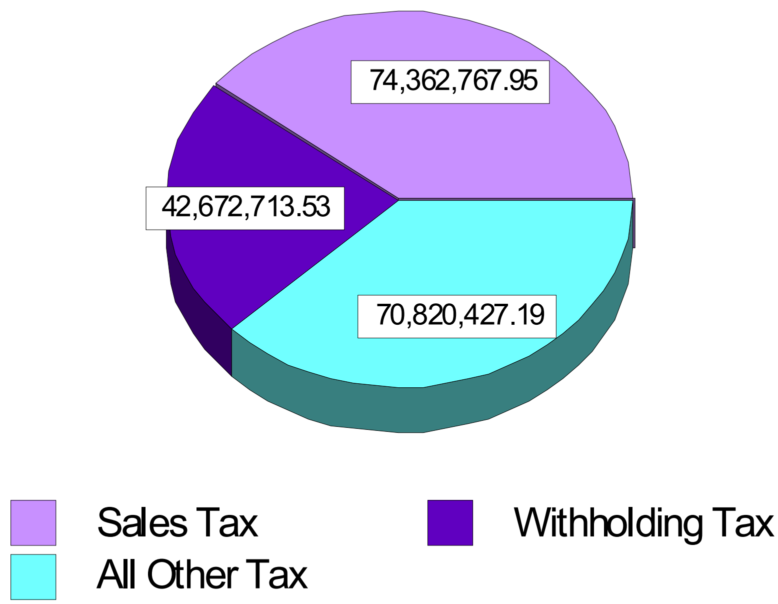
The Department of Tax and Revenue (Tax Department) has accounts of unpaid business tax liabilities that are five years or older that total more than $187 million as shown in Figure 1. Most of this amount will likely not be collected. The Legislative Auditor finds that a primary reason for a large amount of the unpaid business tax liabilities is that the Tax Department does not adequately minimize the amount of debt that delinquent businesses accrue, particularly trust fund taxes such as sales and wage withholding taxes. Some of the Tax Department's enforcement methods have extended lag times between when a company becomes delinquent and when the Department responds, which allows unpaid tax liabilities to grow to an unmanageable level. This is further compounded by the Tax Department's reluctance to use its authority to revoke or deny renewal of the business registration certificate (business license) as a means to limit the growth of unpaid tax liabilities. The Legislative Auditor found that the Tax Department routinely renews business licenses for delinquent companies that have liens and warrants filed against them, that have not filed tax returns for several tax periods, and that owe thousands of dollars and are not on payment plans. By not using the authority to revoke or deny renewal of business licenses, the Tax Department does not minimize the loss of millions of dollars in tax revenue to the State.

Of the $187 million unpaid business taxes, consumer sales and wage withholding taxes account for more than $117 million or 62% of the total balance due.

Figure 1

Unpaid Business Taxes

Accounts Five Years or Older



The Tax Department indicated that it does not revoke or deny renewing business licenses for tax delinquency because it does not consider it an effective tool for collecting unpaid taxes. The Department contends that if companies are denied the ability to conduct business, they will not have the financial ability to pay the taxes they owe. However, an analysis of the former Workers' Compensation Commission's[1] use of revoking business licenses through the Tax Department suggests that it is effective in bringing companies into good standing with their financial obligations.

The Tax Department indicated that it does not revoke or deny renewing business licenses for tax delinquency because it does not consider it an effective tool for collecting unpaid taxes.

Tax Department Employees Express Concern Over the Department's Leniency

The Legislative Auditor conducted a survey of Tax Department employees. Two hundred and eighty eight (288) employees responded to the survey. Most employees thought that they were properly trained to

[1] The Workers' Compensation Commission no longer exists, and its function has been assumed by Brickstreet Insurance Company, an employers' mutual insurance company. All references to the Commission are for when the Commission was still in operation.

perform their jobs, that the agency was successful, responsive, and had clear procedures that are implemented properly. One survey question asked employees how they would rate the agency's aggressiveness in collecting late or delinquent taxes. Nighty-eight (98) employees (34%) indicated that the agency was aggressive and 17 (6%) thought the agency was very aggressive. However, 149 (52%) employees felt that the Tax Department was somewhat aggressive and 24 (8%) employees thought the agency was not aggressive at all. The comments below are concerns some employees expressed as they relate to the Tax Department's enforcement of tax liabilities.

> **Employee 1:** *The unit I work in sees a lot of accounts that as a whole, owe big $$$$ [money] that I wonder what happened or why nothing was done to stop the company to keep accruing big tax liabilities .....as a whole, I believe something needs to be done to stop companies from operating if they don't pay their taxes.*
>
> **Employee 2:** *In my experience as an auditor, [I] have run across numerous delinquent taxpayer accounts where tax has not been paid for several years. In some cases, this has been trust taxes. Taxpayer should not be allowed to renew various business licenses (BFRS, ABC, Contractors, etc) if their accounts are behind in payment.*
>
> **Employee 3:** *It should be made much more easy to revoke a business license. We have numerous businesses that owe thousands of dollars and are not even filing current returns and will never pay what they owe.*
>
> **Employee 4:** *Difficulties in enforcement due to poor information systems and a unwritten policy to "friendly" not aggressive in enforcement.*
>
> **Employee 5:** *IT SEEMS LIKE ITS ALRIGHT TO FILE BUT NOT TO PAY.*
>
> **Employee 6:** *A harder line should be taken with respect to individuals and businesses with outstanding tax liabilities. There are several ways this could be accomplished. For instance, businesses that are delinquent, could be denied their business registration certificate (commonly called a*

business license) renewal. That would force businesses to either get current on their tax obligations, or operate their business without a business license, a criminal offense. Currently renewals are not checked to see if the business is delinquent.

Employee 7: *There needs to be established procedures that close the taxpayers business until they pay outstanding taxes. Now, businesses can keep operating and still owe taxes that keep accruing– that shouldn't be happening.*

While Tax Department employees consider the agency to have overall good performance, some employees have reservations concerning the agency's enforcement of tax liabilities.

While Tax Department employees consider the agency to have overall good performance, some employees have reservations concerning the agency's enforcement of tax liabilities. The Legislative Auditor shared this concern and decided to evaluate the agency's enforcement efforts, and determine if revocation or refusal to renew a business license could prove effective in the collection of delinquent taxes.

Business Licenses Renewed Without Regard for Delinquent Taxes, Liens or Warrants

The Delinquency Notice program that is a significant part of the Compliance Division's enforcement efforts has a timing deficiency that allows businesses to accrue large unpaid tax liabilities before a revenue agent attempts to collect from the company.

The Compliance Division within the Tax Department is responsible for enforcement of state tax liabilities. Presently, the Compliance Division uses several enforcement methods to collect delinquent taxes. These methods include statements, jeopardy assessments, officer assessments, estimated assessments, successor in business assessments, tax liens, payment plans and levies. Also, the Compliance Division relies significantly on the Delinquency Notice program that notifies taxpayers of delinquent tax filings and revenue agents pursue those taxpayers identified by the program.

The Legislative Auditor acknowledges that these enforcement methods can be effective, and the Compliance Division was successful in collecting $82 million in 2005. However, some of these enforcement methods have serious deficiencies. For example, the Delinquency Notice program that is a significant part of the Compliance Division's enforcement efforts has a timing deficiency that allows businesses to accrue large unpaid tax liabilities before a revenue agent attempts to collect from the company. Comments made by surveyed agency employees explain the deficiencies:

> **Employee 8:** *In the Compliance Division, it is a year before the agents know of the delinquencies and that occurs through "Delinquency Notice" runs that are six months past due. Unless taxpayer is reported or volunteers to come forth, the agents are not aware. By this time it is too overwhelming and not enough staff to do an adequate performance.*

> **Employee 9:** *System currently used, allows too much time to elaspe [elapse] before taxpayers are notif[i]ed that returns have not been filed (DELI[N]QUENCY NOTICES). The AREC system of billing for unpaid taxes allows taxpayers up to a year of [or] more before the account is transferred from Charleston Internal Collections to a Revenue Agent in Regional Offices to make contact with the taxpayers and began collection efforts.*

The Tax Department does not check the account tax status of companies before it renews a business license. This allows companies to accrue larger unpaid tax liabilities that may never be collected.

These comments highlight an essential problem with the Compliance Division's enforcement efforts. Although the Division is successful in collecting delinquent taxes through the Delinquency Notice program, it has a significant lag time in notifying its revenue agents of tax delinquencies. Consequently, **the Delinquency Notice program allows many businesses to accrue larger unpaid tax liabilities before the Division begins pursuing the taxpayer.**

Another enforcement tool that has a timing deficiency is the use of tax liens. By law the duration of a tax lien is 10 years (§11-10-12). Evidence suggests that there is a tendency by some companies to ignore tax liens. One Tax Department employee touched on this issue with the following comment:

> **Employee 10:** *People can simply wait out our tax liens knowing that we rarely foreclose on businesses and almost never foreclose on homes.*

The amount of time that elapses between when a lien is issued and when a company responds can be years. It is possible that the Tax Department encourages this because it issues a tax lien by the Compliance Division, yet the Business Registration Section will renew that business' license despite the lien. **The Tax Department does not check the account tax status of companies before it renews a business license. This allows companies to accrue larger unpaid tax liabilities that may never be**

collected.

The Legislative Auditor found that of the 159 companies, the Tax Department renewed 24 (15.09%) business licenses of companies that were delinquent at the time of renewal.

Table 1 shows the results from a sample of 159 companies that were scheduled to have their business licenses revoked at the request of the Workers' Compensation Commission because they were on the workers' compensation default list. The Legislative Auditor reviewed these companies' tax accounts to determine what their payment history was with the Tax Department. The Legislative Auditor found that of the 159 companies, the Tax Department renewed 24 (15.09%) business licenses of companies that were delinquent at the time of renewal. Some did not have tax returns filed for several tax periods, and who owed thousands of dollars with active billings, liens, or warrants filed against them by the Tax Department.

Of these 24 accounts, only 6 were on payment plans. Three out of the six companies with payment plans defaulted before the agreements were fulfilled. It is important to note that not all of these payment plan arrangements were in effect at the time the business licenses were renewed. It should also be noted that in a 1999 performance audit by the Legislative Auditor, it was estimated that businesses on payment plans between 1997 and 1999 paid only 51% on average of the amount required by the payment plan during each year.

The amount of debt owed by these 24 companies that had active statements, assessments, liens and warrants totaled over $405,000 at the time their business licenses were renewed.

Also, Table 1 shows the amount of debt owed by these 24 companies that had active statements, assessments, liens and warrants totaled over $405,000 at the time their business licenses were renewed. It can be seen that at the time of the Legislative Auditor's review of these accounts, the delinquent tax liabilities had grown to over $453,000.

Table 1 Business Registration Renewals of Delinquent Tax Accounts From a Sample of 159 Accounts				
Active Account Status at Time of Business License Renewal	Number (Percentage) of Active Accounts That Were Delinquent at Time of Renewal	Number of Accounts With Payment Plans	Amount Owed at Time of Business License Renewal	Amount Owed at Time of Legislative Review
Statements/Assessments	5 (3.14%)	1	$13,126	$38,422
Liens/Warrants	19 (11.95%)	5	$392,401	$415,143
Totals	24 (15.09%)	6	$405,527	$453,565

Source: PERD analysis of the account status of a sample of 159 accounts that were scheduled for revocation of business licenses at the request of the Workers' Compensation Commission because companies were on the workers' compensation default list.

Company A is the most egregious case in which the company's business license was renewed in June 2005 despite the Department's knowledge that over 100 monthly sales tax returns had not been filed dating back to 1990, an estimated amount over $150,000 was owed, with three active warrants, one active lien, one statement and two assessments, and no payment plan arrangement.

Table 2 shows 2 of the 24 companies taken from the sample of workers' compensation cases. These two cases show how unpaid tax liabilities are allowed to increase. Company A is the most egregious case in which the company's business license was renewed in June 2005 despite the Department's knowledge that over 100 monthly sales tax returns had not been filed dating back to 1990, an estimated amount over $150,000 was owed, with three active warrants, one active lien, one statement and two assessments, no payment plan arrangement, and with no evidence of operating with a valid business license in 1993 and between 1999 and 2004.

While the Tax Department did well in placing Company B on a payment plan early, allowing the company to violate the payment plan and add further delinquencies is not appropriate enforcement. This practice allows unpaid tax liabilities to be higher than they should.

Company B filed three monthly sales tax reports but without remittance in 2000. The total amount owed was over $8,000. The company was put on a payment plan. Part of the agreement of all payment plans is that the company must timely pay current taxes while they are on a payment plan from past delinquency. In 2001, Company B filed six monthly sales tax reports without remittance for a total amount of over $7,000, and in 2002, 6 monthly sales tax returns were filed without remittance totaling over $6,400. These delinquencies violated the terms of the 2000 payment plan. Nevertheless, the Tax Department renewed the business license which allowed the company to accrue larger unpaid tax liabilities. By 2004, the business was on a payment plan owing over $22,000. The company's business license was eventually revoked by request of the Workers' Compensation Commission. It appears that the company made payments to the Tax Department on the payment plan as of September 2005. It may be years before the amount owed is paid or the company may stop paying the tax liability. While the Tax Department did well in placing Company B on a payment plan early, allowing the company to violate the payment plan and add further delinquencies is not appropriate enforcement. This practice allows unpaid tax liabilities to be higher than they should.

Table 2 Two Examples of Delinquent Businesses			
Year	**Company A**	Year	**Company B**
1990-98	89 Mthly Sales Tax Reports Not Filed No Qtrly WW Reports Filed in 92, 93, 94 **Business License Renewed in 90, 91, 92, 94, 95, 96, 97, 98** **No Record of Renewal for 1993**	1998	No Enforcement Activity Recorded **Business License Renewed**
1999	No Monthly Sales Tax Reports Filed 2 Qtrly WW Tax Returns Not Filed **No Record of Business License Renewal**	1999	No Enforcement Activity Recorded **Business License Renewed**
2000	No Monthly Sales Tax Reports Filed No Qtrly WW Tax Returns Filed Estimated Sales Tax Owed for 1990-1997 = $109,733	2000	3 Monthly Sales Tax Reports Filed Without Remittance. Amount Owed= $8,176 Company Put on Payment Plan
2001	Estimated Sales Tax Owed for 1998-1999 = $24,341 **No Record of Business License Renewal**	2001	6 Monthly Sales Tax Reports Filed Without Remittance. Amount Owed = $7,182 and added to Payment Plan **Business License Renewed**
2002	2 Liens Issued	2002	6 Monthly Sales Tax Reports Filed Without Remittance. Amount Owed = $6,402 and added to Payment Plan
2003	5 Monthly Sales Tax Reports Filed Without Remittance= $3,148 owed. **No Record of Business License Renewal**	2003	3 Liens Issued, 4 Warrants Issue
2004	Estimated Sales Tax Owed for 3/03 = $575.76	2004	Total Amount Owed= $22,820 8 Active Warrants **Business License Renewed 8/04**
2005	Total Estimated Sales Tax Owed = $150,789 1 Active Lien, 3 Active Warrants **Business License Renewed**	2005	**Business License Revoked in 12/04 at the Request of Workers' Compensation Commission**
Source: PERD Analysis of State Tax Department's Business Accounts Receivables Data.			

The Tax Department Claims Revocation or Denying Renewal of Business Licenses Is Ineffective

It is evident that business license revocation had been rarely used by any agency until 2005 when the Workers' Compensation Commission began invoking the authority it received in 2004 to request the Tax Department revoke business registration certificates of defaulted workers' compensation policyholders.

Table 3 shows the frequency in which business licenses are revoked by the Tax Department. For years from 2000 to 2004 only a few business licenses were revoked and it is not known what state agency initiated the revocation. They could have been revoked by the Tax Department, or at the request of the Division of Unemployment Compensation for unpaid unemployment compensation. It is evident that business license revocation had been rarely used by any agency until 2005 when the Workers' Compensation Commission began invoking the authority it received in 2004 to request the Tax Department revoke business registration certificates of defaulted workers' compensation policyholders.

Table 3
Business License Revocations by Year

Year	Number of Revocations
2000	4
2001	3
2002	
2003	2
2004	2
2005*	621

Source: WV Department of Tax and Revenue
* Through November 2005

This shows that allowing businesses to go years without filing tax returns or paying taxes has been common for a considerable amount of time.

When the Legislative Auditor asked the Tax Department why it does not revoke or deny renewal of business licences as an enforcement tool against delinquent businesses, the Compliance Division stated that:

> Tax Department memoranda have been located which clearly indicate that Compliance Division management determined long years ago that business registration certificate revocation is a tax enforcement tool that should be applied sparingly.

Also included with its response were copies of six 1986 and 1987 administrative decisions where the Tax Department revoked the business registration certificates of delinquent taxpayers who had not paid taxes or filed tax returns in several years. **This shows that allowing businesses to go years without filing tax returns or paying taxes has been common for a considerable amount of time.**

In addition to the reason stated above, the Compliance Division gave other explanations for not revoking or refusing to renew business registrations of delinquent taxpayers. First the Compliance Division contends that revocation is not the most effective enforcement method.

> In terms of dollars of revenue collected, business registration certificate revocations and suspensions represent absolutely no return to the State. A shutdown business will typically never pay its delinquent taxes, and will certainly never pay future taxes.

The Division holds that, "*In all but the most egregious cases, these Taxpayers can be more productive in getting arrearages caught up, and in maintaining current tax payments if they are given a simple payment plan and some counseling by the Tax Department.*"

The Compliance Division also stated that revocations and refusal to renew would create an unmanageable burden on the Tax Department and would not be cost effective.

The Legislative Auditor does not agree that a business license revocation process would be burdensome, and it is not being suggested that the business license of every company that is in arrears be revoked.

> The complete shutdown of businesses to which these 59,923 billings are attributable, the likely number of legal tax appeals associated with any such shutdowns, and the ensuing Tax Department enforcement actions and prosecution against noncompliant taxpayers would create an unmanageable burden on the Tax Department resources, with litigation and enforcement costs that would soon place the State in a very problematic position.

The Legislative Auditor does not agree that a business license revocation process would be burdensome, and it is not being suggested that the business license of every company that is in arrears be revoked. License revocation should be used in cases in which taxpayers persistently do not respond appropriately to other enforcement methods. Since the State changed the duration of a business license from one year to two years in 1999, the State cannot afford to allow delinquent businesses the extra year to accrue unpaid tax liabilities. After reviewing the 1986 and 1987 administrative decisions in which the Tax Department revoked business licenses, the Legislative Auditor observed that in all six cases the taxpayer failed to appear at the "show cause informal hearing." The Legislative Auditor concludes that excessive appeals are improbable and appeals will most likely occur only when there is a material issue. Companies are more likely to make arrangements with the Tax Department or will simply allow the license to be revoked without appeal. Furthermore, prior to the renewal of business licenses, the Tax Department should determine the account status of those companies and inform them that renewal is contingent upon the companies becoming current in their tax liabilities or establish a payment plan with the Tax Department as the law allows.

Workers' Compensation Data Prove Revocation and Denying Renewal are Effective

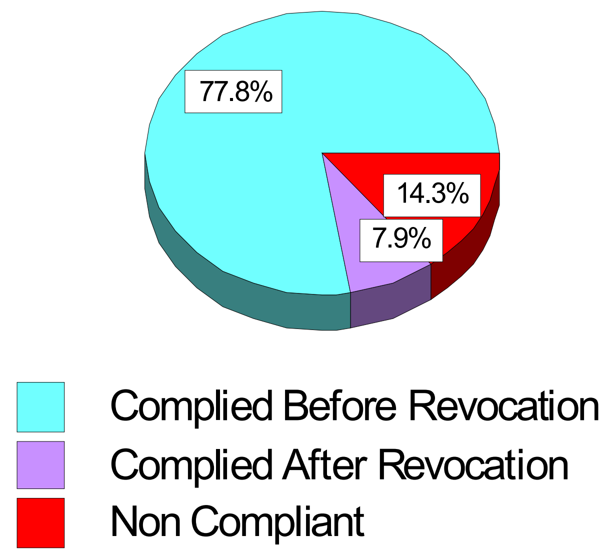
Of the 4,390 companies, 77.8% (3,414) complied with the WCC to avoid license revocation, and 7.9% (345) complied after their business licenses were revoked, totaling 85.7% in compliance.

Action taken by the Workers' Compensation Commission (WCC) proves that revoking business registration certificates can be effective. In 2004 the WCC was given the statutory authority to request the Tax Department to revoke or refuse renewal of a company's business registration certificate for delinquent Workers' Compensation policy premiums. The policy was implemented in December of 2004. As of November 2005 a total of 4,390 companies had been notified that their business registration certificates were scheduled to be revoked. Of the 4,390 companies, 77.8% (3,414) complied with the WCC to avoid license revocation, and 7.9% (345) complied after their business licenses were revoked, totaling 85.7% in compliance. The remaining 631 companies or 14.3% took no action and allowed their business licenses to be revoked.

According to the WCC, as of July 31, 2005, it had collected approximately $997,500 from previously defaulted accounts.

Figure 2 illustrates the compliance rates of defaulted workers' compensation policyholders who were scheduled to have their business licenses revoked. It is important to note that of the 631 companies that did not respond, not all of them were actively doing business. Several had been out of business and neglected to inform the WCC, which resulted in defaulted workers' compensation premiums. According to the WCC, as of July 31, 2005, it had collected approximately $997,500 from previously defaulted accounts. These data show that more often than not a company who desires to stay in business will meet its financial obligations when its business license is in jeopardy. Therefore invoking an entity's right to deny renewal or revoke a business registration certificate can be an effective practice for collecting financial obligations.

Figure 2
Compliance Rates
Defaulted Workers' Compensation Policyholders



According to West Virginia Code §23-2-5 in order for an employer to be in compliance with workers' compensation, all reports must be both filed and paid. This means that even if there is no balance due, the employer must file reports timely or he or she will be in default, which can result in the employer's business license being revoked. The Legislative Auditor took a random sample of policyholders who complied with the WCC before revocation and a random sample from those policyholders who complied with the WCC after revocation. Table 4 breaks down the two samples into three groups: 1) policyholders who were delinquent in filing payroll reports and owed nothing; 2) those who entered into payment agreements; and 3) policyholders who paid the balance due or a settlement amount. These figures were determined by calculating the percentages for an extrapolation of the sample and then applying those rates to the entire universe (3759 policyholders).

Table 4
Types of Workers' Compensation Compliance
Companies That Either Complied to Avoid License Revocation or After License Was Revoked

	Policyholders Who Filed Missing Reports and Owed $0.00	Policyholders Who Entered Into Payment Agreements	Policyholders Who Paid Balance Due or Settlement Amount
Sample 1 (Avoided Revocation)	20%	16%	64%
Sample 2 (After Revocation)	40%	4%	56%
Overall	21.8%	14.9%	63.3%

Source: PERD analysis of data provided by the Workers' Compensation Commission.

According to Receivables Management at Brickstreet Insurance Company, appeals were minimal. Ultimately a company must appeal the validity of the debt owed and not the actual revocation or refusal to renew. Appendix B shows a sample of individual amounts owed and paid by delinquent policyholders before and after the business license was revoked.

The collection of $101 million has been attributed to Maryland's refusal-to-renew policy.

Maryland's Refusal-to-Renew Policy Reaps Noteworthy Results

In 2003 the Maryland Legislature incorporated a refusal-to-renew provision into statutes dealing with occupational and professional licensing. The provision applies to occupational and professional licenses and requires specific licensing agencies and boards to obtain clearance each year from the Office of the Comptroller before renewing a professional license. According to the Director of the Maryland Compliance Division, there have been no appeals since the implementation of the legislation. Because the statute is found within each licensing agency's code, if an applicant would appeal the licensing agency's refusal to renew the professional license, the agency could simply cite the code. As a result, the only recourse available to the applicant is to contest the validity of the tax liability owed. The collection of $101 million has been attributed to the refusal-to-renew policy. It should be noted that a portion of that money would have been collected without the program, however the collection process was accelerated allowing the Maryland Tax Department to use its resources more effectively.

The authority to revoke or refuse to renew a business license is the Tax Department's strongest and most effective enforcement method.

Since West Virginia's business registration cycle is two years, refusal to renew as the only enforcement tool would not be effective in all situations. With the longer duration of a business license, unpaid tax liabilities could grow to an excessive level before the renewal date. Therefore, refusal to renew as well as revocation are needed in order for the Tax Department to effectively deter and prevent the accumulation of delinquent tax liabilities.

The Effects of the Tax Department's Leniency Are Significant

The policy that the Tax Department has in place with respect to delinquent companies essentially allows them to pay their taxes on their terms. There is a relatively low deterrent factor and there is no stop measure to limit delinquent amounts.

The results from revoking business licenses of companies in default with workers' compensation show that license revocation is effective. Contrary to the Tax Department's contention, companies that face the possibility of losing their business licenses are more likely to pay their tax liabilities or make arrangements to come into compliance. The authority to revoke or refuse to renew a business license is the Tax Department's strongest and most effective enforcement method. **The Tax Department's current belief that threatening revocation will result in closing a business and collecting no revenue is born from a long practice of allowing companies to accrue large unpaid tax liabilities that are difficult to impossible to pay.** The Tax Department must intervene sooner to avoid unmanageable delinquencies that will result in no collection of revenue when it informs companies of revocations or the refusal to renew business licenses.

The policy that the Tax Department has in place with respect to delinquent companies essentially allows them to pay their taxes on their terms. **There is a relatively low deterrent factor and there is no stop measure to limit delinquent amounts.** The consequences of the Tax Department's current enforcement approach towards delinquent companies are:

1. There is a relatively low deterrent factor against companies accruing large unpaid tax liabilities.

2. Businesses that are allowed to operate for years without filing tax returns or paying due taxes are given an unfair advantage over their competitors.

3. The Tax Department is not minimizing the loss of revenue to the State.

4. The Tax Department wastes valuable resources pursuing delinquent companies who take advantage of the Department's leniency.

Companies that do not pay trust fund taxes when due are violating their fiduciary responsibilities and have taken funds that do not belong to them for personal use.

The Tax Department Should Take a Tougher Stand on the Non-Payment of Trust Fund Taxes

The majority of delinquent business taxes are consumer sales and wage withholding taxes. These are considered trust taxes because they are collected and held in trust for the State of West Virginia (WVC §11-10-5j). The consumer sales and wage withholding taxes that are imposed and collected by companies represent tax liabilities of other individuals. By law, a person who fails to account for and pay to the Tax Department the amount collected of another person's tax liability is guilty of a felony if the amount of unpaid tax is $1,000 or more and has not been paid and accounted for more than 30 days after the due date (WVC §11-9-5). Companies that do not pay trust fund taxes when due are violating their fiduciary responsibilities and have taken funds that do not belong to them for personal use. The Tax Department does well in imposing penalties, additions, and interest for late payment of taxes. However, the Legislative Auditor contends that the Tax Department does not send an appropriate message to companies when it renews the business licenses of companies that have not filed tax returns or paid trust taxes for several tax periods, that have numerous assessments, liens and warrants filed against them, and who are not on payment plans. **This policy allows companies to place a relatively low priority on paying trust taxes compared to their other financial obligations. For an offense that carries a felony charge, with a possible sentencing of one to three years imprisonment (WVC §11-9-5), the Tax Department's policy towards delinquent businesses should more appropriately reflect the seriousness of the offence.**

The Legislative Auditor contends that the Tax Department does not send an appropriate message to companies when it renews the business licenses of companies that have not filed tax returns or paid trust taxes for several tax periods, that have numerous assessments, liens and warrants filed against them, and who are not on payment plans.

Payment Plans Should Be Centralized

It can create inequity between companies if payment plans have variations in how they are established between payment plans in regional offices and in Thumbtax.

Currently, the Tax Department has most payment plans for delinquent companies in a centralized database called Thumbtax. This allows the Tax Department to monitor payment plans. However, the Tax Department also allows payment plans to be established at the regional level. When the Legislative Auditor requested payment plan information on workers' compensation accounts, the information had to be obtained from regional offices. The central office was unaware if payment plans existed for several of the companies. This practice is not adequate for oversight of payment plans and the practice can also put tax revenues at risk of impropriety. Furthermore, it can create inequity between companies if payment plans have variations in how they are established between payment plans in regional offices and in Thumbtax. The Tax Department should consider having all payment plans centralized for better oversight and reduce the risk of impropriety and inequity between companies on payment plans.

Conclusion

While it is acknowledged that the Tax Department collected over $82 million in 2005 through its Compliance Division, the Legislative Auditor contends that a significant amount of the unpaid business taxes has resulted because the Tax Department does not adequately minimize the amount of debt that delinquent businesses accrue.

At the time of this review, accounts of unpaid business taxes that were five years or older totaled more than $187 million. While it is acknowledged that the Tax Department collected over $82 million in 2005 through its Compliance Division, the Legislative Auditor contends that a significant amount of the unpaid business taxes has resulted because the Tax Department does not adequately minimize the amount of debt that delinquent businesses accrue. Some of the Tax Department's enforcement methods have considerable lag times between when a company becomes delinquent and when the Department responds. This allows unpaid tax liabilities to grow to an excessive level. For this reason, it is important that the Tax Department use its statutory authority to revoke or refuse to renew business licenses as a means to limit the growth of unpaid business taxes. Currently, the Tax Department renews business licenses without concern for the account status of businesses. It is common for the Tax Department to renew business licenses for companies that have assessments, liens and warrants against them, that have not filed tax returns or paid due taxes for several tax periods. These companies often owe thousands of dollars and many are not on payment plans. A 1999 audit indicated that even when payment plans were established, only an average of 53% of the required monthly payments were being paid.

The use of revocation and refusal to renew as an enforcement tool has been proven effective and successful by the Workers' Compensation Commission and the State of Maryland as well.

Furthermore, of the $187 million unpaid business taxes, consumer sales and wage withholding taxes account for more than $117 million or 62% of the total balance due. These taxes are collected from customers or withheld from employee wages, held in trust, to be remitted to the State on or before the appropriate due date. Employers who do not pay these taxes and use the money for personal use are not fulfilling their fiduciary responsibility. Such action is a felony under current law for amounts of $1,000 or more. The Tax Department's policy towards delinquent businesses should more appropriately reflect the seriousness of the offence.

The Tax Department's leniency towards delinquent business creates an unfair advantage for the competitors of delinquent companies, and it does not result in an efficient use of resources.

The use of revocation and refusal to renew as an enforcement tool has been proven effective and successful by the Workers' Compensation Commission and the State of Maryland as well. Since the Tax Department issues business registration certificates for a term of two years instead of one year, the Legislative Auditor contends that it is necessary to incorporate not only a refusal-to-renew policy, but also revocation in situations when waiting for the renewal date would be costly to the State. While the Tax Department does well in collecting delinquent tax liabilities overall, the Legislative Auditor concludes that the Tax Department's most effective enforcement tool is the authority to refuse renewal and revocation of business licenses. This enforcement tool could be very effective in limiting revenue losses and enhancing the Department's collection of revenue. Moreover, the Tax Department's leniency towards delinquent business creates an unfair advantage for the competitors of delinquent companies, and it does not result in an efficient use of resources.

In light of this stance by the Legislature against companies delinquent in workers' compensation, it is inconsistent for the Tax Department to have its current policy when the delinquency of taxes involves a greater loss of revenue.

In 2004, the West Virginia Legislature acknowledged the need to take a more forceful approach to companies delinquent in workers' compensation by granting the WCC the authority to request the revocation of business licenses for companies that were in default in workers' compensation. In light of this stance by the Legislature against companies delinquent in workers' compensation, it is inconsistent for the Tax Department to have its current policy when the delinquency of taxes involves a greater loss of revenue.

Recommendations

1. *The Legislative Auditor recommends that the Department of Tax and Revenue utilize the authority granted in §11-12-5 of the West Virginia Code as an enforcement tool.*

2. *The Legislative Auditor recommends that the Department of Tax and Revenue promulgate rules for applying §11-12-5 of the West Virginia Code.*

3. *The Legislative Auditor recommends that the Department of Tax and Revenue establish policy and procedures to make renewal of business registration certificates contingent upon if a company's account is in good standing with the Department.*

4. *The Legislative Auditor recommends that the Tax Department discontinue the practice of allowing payment plans to be established at regional offices and have all payment plans centralized.*

Appendix A: Transmittal Letter

WEST VIRGINIA LEGISLATURE

Performance Evaluation and Research Division

Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610
(304) 347-4890
(304) 347-4939 FAX

John Sylvia
Director

May 1, 2006

John C. Musgrave, Acting Cabinet Secretary
Department of Revenue
Room W-300, State Capitol
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305

Dear Secretary Musgrave:

This is to transmit a draft copy of the Full Performance Evaluation of the Department of Tax and Revenue. This report is scheduled to be presented during the May 21-23 interim meeting of the Joint Committee on Government Operations. We will inform you of the exact time and location once the information becomes available. It is expected that a representative from your agency be present at the meeting to orally respond to the report and answer any questions the committee may have.

We need to schedule an exit conference to discuss any concerns you may have with the report. We would like to have the meeting on any day from May 3 to May 5, 2006. Please notify us to schedule an exact time. In addition, we need your written response by noon on May 10, 2006 in order for it to be included in the final report. If your agency intends to distribute additional material to committee members at the meeting, please contact the House Government Organization staff at 340-3192 by Thursday May 18, 2006 to make arrangements.

We request that your personnel not disclose the report to anyone not affiliated with your agency. Thank you for your cooperation.

Sincerely,

John Sylvia

John Sylvia

JS/am

Enclosure

c: Virgil T. Helton, Acting Tax Commissioner
Jeff Oakes, Compliance Division Director

Joint Committee on Government and Finance

Appendix B: Payments of Delinquent Workers' Compensation

Workers' Compensation Policyholders who Complied Before Revocation		
Control Number	**Balance Due***	**Payment**
1	$ 28,298.47	$ 27,158.61
2	$ 465.84	$ 318.30
3	$ 1,808.24	Entered repayment plan
4	$ 228.37	Filed missing reports
5	$ 78.29	$ 28.29
6	$ 334.36	Filed missing reports
7	$ 2,170.76	$ 1,000.00
8	$ 104.34	$ 266.68
9	$ 126.02	$ 115.77
10	$ 50.53	$ 75.00
11	$ 61.60	$ 61.60
12	$ 335.51	Filed missing reports after terminating
13	$ 5,220.42	Entered repayment plan
14	$ 940.56	Filed missing reports after terminating
15	$ 1,424.12	$ 1,250.00
16	$ 235.14	$ 418.80
17	$ 101.26	$ 105.00
18	$ 21,976.29	$ 7,374.73
19	$ 352.44	$ 172.22
20	$ 134.17	$ 130.00
21	$ 9,465.44	Entered repayment plan
22	$ 162.17	$ 2,630.73
23	$ 4,922.25	Entered repayment plan
24	$ 2,261.02	Filed missing reports
25	$ 387.75	$ 402.81

Source: Workers' Compensation Commission (Now Brickstreet Insurance Company)
* Balance due in some cases is estimated and may be subject to change when reports are filed.

Workers' Compensation Policyholders who Complied After Revocation		
Control Number	**Balance Due***	**Payment**
1	$ 1,266.42	$ 415.91
2	$ 3,437.93	$ 3,437.93
3	$ 2,202.66	Policy cancelled after all reports were filed balance was $0
4	$ 726.65	$ 242.98
5	$ 432.99	$ 125.80
6	$ 75.61	$ 181.10
7	$ 135.81	$ 350.00
8	$ 4,473.39	Policy cancelled after all reports were filed balance was $0
9	$ 600.08	Policy cancelled after all reports were filed balance was $0
10	$ 75.75	Filed missing reports
11	$ 209.00	Policy cancelled after all reports were filed balance was $0
12	$ 1,205.49	Policy cancelled after all reports were filed balance was $0
13	$ 1,908.69	$ 1,941.05
14	$ 980.73	$ 578.85
15	$ 4,437.92	$ 4,703.72
16	$ 232.33	$ 257.33
17	$ 159.61	Policy cancelled after all reports were filed balance was $0
18	$ 796.43	$ 313.74
19	$ 1,887.77	Placed on repayment agreement
20	$ 834.43	$ 413.00
21	$ 444.38	Policy cancelled after all reports were filed balance was $0
22	$ 1,031.65	Policy cancelled after all reports were filed balance was $0
23	$ 488.59	Policy cancelled after all reports were filed balance was $0
24	$ 231.53	$ 429.00
25	$ 101.62	$ 64.93

Source: Workers' Compensation Commission (Now Brickstreet Insurance Company)
* Balance due in some cases is estimated and may be subject to change when reports are filed.

STATE OF WEST VIRGINIA
Department of Revenue
State Tax Department

Joe Manchin III
Governor

May 18, 2006

West Virginia Legislature
Performance Evaluation and Research Division
Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610

RECEIVED
MAY 18 2006
PERFORMANCE EVALUATION AND RESEARCH DIVISION

Dear Mr. Sylvia:

The purpose of this letter is to provide you with the Tax Department response to the Full Performance Evaluation of the Department of Tax and Revenue, sent to Secretary John Musgrave on May 1, 2006, submitted by John Sylvia, Director of the Performance Evaluation and Research Division. Prior to addressing the shortcomings outlined in the report, it is important to consider the accomplishments and the current work environment within the Compliance Division of the State Tax Department.

The Compliance Division has demonstrated its diligence in the pursuit of delinquent taxes. The thirty-three Revenue Agents of the Division have added approximately one half a billion dollars to the State coffers for the calendar years 2000 through 2005, with average deposits of eighty-nine million dollars per year for the period. On average, this equates to the collection of approximately $2.7 million per revenue agent per year. These are monies that would not have otherwise have been collected. This performance level has been accomplished despite the lack of modern collection technology.

The Department has long recognized the need to address the lack of technology. Fortunately, due to the efforts Governor Manchin and the Legislative Leadership, the State Tax Department received a twenty-two (22) million dollar appropriation to address this need. The Department has begun the three year process of purchasing and installing this new system. This report confirms that this upgrade was desperately needed.

The first assertion put forth in the Evaluation is: **"The State Is Losing Millions in Tax Revenue Because the Tax Department Does Not Use the Full Extent of Its Enforcement Authority"**. After a brief introduction, numerous arguments are provided in support of the assertion. This response will address each argument by order of appearance in the Evaluation.

1

Tax Department Employees Express Concern Over the Department's Leniency

The Legislative Auditor surveyed two hundred and eighty eight (288) Tax Department employees. One survey question asked employees to rate the agency's aggressiveness in collecting late or delinquent taxes. The results of the survey are as follows:

6%	very aggressive
34%	aggressive
52%	somewhat aggressive
8%	not aggressive at all

It should be expected that in any agency that includes diverse personalities, skills, and experiences, differing opinions exist. Given the documented results of the survey, it is our opinion that the heading over this section of the Evaluation would more appropriately read "**Only 8% of Tax Department Employees Believe the Department is Not Aggressive in the Pursuit of Delinquent Taxes**".

The Department uses a wide array of tools in the pursuit of delinquent taxes. Some of these tools are used more aggressively than in other States. One such example is the use of the Notice of Tax Lien. Currently, the Tax Department will file a Notice of Tax Lien in the appropriate county courthouse against any taxpayer who owes the State more than Twenty-Five Dollars ($25.00) in finalized delinquent tax liability. This is a much more aggressive use of tax liens than is practiced in many other states.

Additionally, when the liability is documented on a mathematically correct, signed return, the liability will progress to the lien after only a 15 day notice as required by statute. (§11-10-6(b)) The Notice of Assessment is bypassed. This aggressive approach has proved to be a very successful collection tool.

As discussed above, the Tax Department has contracted with Fast Enterprises to install a twenty-two million dollar integrated tax system. Fast Enterprises has successfully installed and implemented their product in 11 other tax jurisdictions. Fast Enterprises has disclosed to the Department that, in most of the states they have worked with, tax liens are filed on a selective basis. The West Virginia approach is more aggressive than the typical state with which Fast has worked. The Notice of Tax Lien is an extremely effective and often essential tool in the pursuit of delinquent taxes, and the Department aggressively utilizes this and other tools.

The Tax Department acknowledges that simply taking an aggressive approach to the recordation of a tax lien will not work in every case. It is incumbent upon the Department to enforce the collection of liens in a fair and timely manner. The Department has addressed the need to respond to tax deficiencies in an efficient manner. Improved efficiency will be a cornerstone of the new integrated tax system.

2

Business Licenses Renewed Without Regard for Delinquent Taxes, Liens or Warrants

The Compliance Division of the State Tax Department is responsible for the enforced collection of state tax liabilities. The Department utilizes many methods to collect taxes such as statements, jeopardy assessments, officer assessments, estimated assessments, successor in business assessments, tax liens, payment plans, delinquency notices and levies. While the Legislative Auditor acknowledges that these enforcement methods can be effective, and that the Compliance Division has been effective in collecting a significant amount of delinquent tax monies due the state, the auditor contends that current enforcement methods have serious deficiencies.

The Legislative Auditor specifically suggests that the Compliance Division's Delinquency Notice program allows many businesses to accrue larger unpaid tax liabilities before the Division begins pursuing the taxpayer. On this point, the Department agrees. The Delinquency Notice Program notifies taxpayers of tax filing deficiencies and is traditionally run bi-annually. Each "run" produces approximately 40,000 Delinquency Notices that are assigned to 22 Compliance Division Revenue Agents located in the regional offices. Due to our current technological deficiencies, each Delinquency Notice requires a manual action to be initiated by the agent toward the delinquent taxpayer. It is impossible for these agents to address each and every filing deficiency, while performing his or her other duties, before the next Delinquency Run is produced creating another 40,000 notices.

In our current technological environment, the request to produce Delinquency Notices must be submitted to the Department's Information Technology Division. Paper copies of the notices must then be distributed to each revenue agent for manual handling. Absent the request to produce the notices, our current accounts receivable system cannot **autonomously identify** and notify, those taxpayers who have not filed all required returns. As stated earlier, the Tax Department and the Legislature have recognized the need to acquire new software to replace the Department's antiquated accounts receivable systems. Once implemented, the new integrated tax system will, without special request, produce a notice to taxpayers who have failed to file a required return within **days** rather than months. In so doing, filing deficiencies will be addressed in a timely manner as they occur.

Another contention of the Legislative Auditor is that the Division fails to timely pursue forced collection of tax liens. The Auditor states that an excessive amount of time can elapse between the issuance of a tax lien and a company's response to the lien. The Auditor further suggests that the Tax Department may *encourage* this practice because the Business Registration Section of the Tax Department will renew a business license despite a lien, and that the Department does not check the tax status of an account before it renews a business license.

The Department objects to the assertion that it encourages taxpayers to delay their response to a recorded tax lien. In the Department's current technological environment, it is impossible to automatically determine that a finalized liability exists for a taxpayer who is

3

scheduled for business license renewal. The system that renews a business license cannot determine that a finalized liability exists for a taxpayer. The determination of this condition is currently a manual process. The Department issues approximately 95,000 business license renewals each year. A Department employee would have to manually determine in each case that a finalized liability or a filing deficiency exists for each taxpayer scheduled for renewal before granting or denying the renewal. The Department's Business Registration Section consists of 6 employees and lacks the human resources to engage in this activity.

The Tax Department is not in the business of putting people out of business.

A business with a tax arrearage has a fighting chance of recovering its financial position and paying his tax debts if the business is allowed to operate under a carefully monitored payment plan, and is given an opportunity to show improvement and ultimately pay its debts.

A business that has had its business license revoked has been shut down. It has no opportunity to operate, no hope of recovery and no hope of paying its debt to the State of West Virginia.

The Legislative Auditor provides 24 examples of companies that were delinquent in their State tax filings at the time of renewal. The examples show that not all of these companies had payment plan, and many had failed to file all required returns. The Department acknowledges that the Legislative Auditor correctly represent the facts relating to these cases. These examples highlight the desperate need for an automated case management system within the Department. Currently, collection cases must be built manually, maintained manually, and to a great extent pursued manually. Managers cannot review a comprehensive listing of all collection cases in an employee's inventory, and in our current environment no automatic risk or aging capabilities exist to assist in the prioritization of collection items. Once implemented, the integrated tax system will correct these deficiencies and will enable agents and managers to ensure that taxpayer accounts are monitored properly, and more efficiently.

Revocation or Non-Renewal of Business Licenses Is Ineffective

The Legislative Auditor has shown that from the years 2000 through 2004 the Tax Department has revoked only 14 business licenses. When the Legislative Auditor inquired as to why the Tax Department does not significantly utilize the refusal to renew or the revocation of business licenses as an enforcement tool against delinquent businesses the following explanations were given:

1) Tax Department memoranda have been located which clearly indicate that Compliance Division management determined long years ago that business registration certificate revocation is a tax enforcement tool that should be applied sparingly.
2) In terms of dollars of revenue collected, business registration certificate revocations and suspensions represent absolutely no return to the State. A

4

shutdown business will typically never pay its delinquent taxes, and will certainly never pay future taxes. In all but the most egregious cases, these Taxpayers can be more productive in getting arrearages caught up, and in maintaining current tax payments if they are given a simple payment plan and some counseling by the Tax Department.

3) For the fiscal year ending June 30, 2005, the Department's accounts receivable system (AREC) issued 59,923 billings to Taxpayers for delinquent liability. The complete shutdown of businesses to which these 59,923 billings are attributable, the likely number of legal tax appeals associated with any such shutdowns, and the ensuing Tax Department enforcement actions and prosecution against noncompliant taxpayers would create an unmanageable burden on the Tax Department resources, with litigation and enforcement costs that would soon place the State in a very problematic position.

The Legislative Auditor contends that allowing businesses to go years without filing tax returns or paying taxes has been common for a considerable amount of time. The Tax Department strongly disagrees with this contention. The Department utilizes many methods to pursue taxpayers who are delinquent in their filing obligations. Tax liens, officer and successor in liability assessments, levies and wage garnishments have proven to be effective collection tools. These methods are commonly used by the Department, and in our current technological environment, a revenue agent must perform most collection actions manually.

Given the current system's lack of a comprehensive case management system, agents must use sound judgment in determining from which taxpayers they have the greatest potential to collect delinquent tax dollars. Extensive use of a refusal to renew or revocation of business registration certificate policy, which would be an entirely manual process, could hinder an agent's ability to collect. Simply put, with limited human and technological resources the Department must determine how to best use these resources.

The Legislative Auditor disagrees that a business license revocation process would be burdensome if used in cases where taxpayers persistently do not respond appropriately to other enforcement methods. The Department agrees that the revocation of business licenses should be considered in the most egregious cases of taxpayer noncompliance. A draft procedure to be used in the process of business registration certificate revocations, as well as criteria to be used in identifying businesses subject to this process is being finalized.

The Legislative Auditor concludes that excessive appeals of a refusal to renew or revocation of a business license certificate are improbable and appeals will most likely occur only when there is a material issue. The Department agrees that if we do not refuse to renew a business registration certificate and only revoke a business registration certificate in the most egregious cases, excessive appeals are unlikely. However, if the revocation policy is not used sparingly, it is certain that the Department would incur significant administrative and staff costs. Enforcement of a significant number of business registration certificate revocations would be impossible or, at best, exceedingly costly to the State.

5

Workers' Compensation Data Prove Revocation and Non-Renewal are Effective

In 2004 the Workers Compensation Commission (WCC) was given statutory authority to request the Tax Department to revoke or refuse renewal of a company's business registration certificate for delinquent Workers Compensation policy premiums. As of November 2005, 4,390 companies had been notified that their business registration certificates were scheduled to be revoked. Statistical data shows that 85.7% of these companies complied with the WCC to avoid revocation. 14.3% took no action and allowed their business licenses to be revoked. The Legislative Auditor states that these results prove invoking the authority to deny renewal or to revoke a business registration certificate can be an effective tool for collecting financial obligations.

The Tax Department does not dispute that the WCC revocation policy has been successful. However, there are other factors to consider before applying the same policy in the Tax Department.

First, according to staff of the Performance Evaluation and Research Division of the West Virginia Legislature the average amount of Workers Compensation premium delinquency of the companies contacted was $400.00. The Tax Department agrees that the smaller the delinquency, the easier it is for taxpayers to comply. The Legislative Audit Performance Evaluation does not indicate how many companies had significant premium liability, and what the compliance rate was for those particular companies.

Second, in certain circumstances, responding to a business registration certificate revocation notice by satisfying all delinquent Workers Compensation premiums may not keep a company in business. Should a company have significant accrued premium liability as well as state tax liability, it may not be possible for that company to comply with both agencies in like manner to retain their business registration certificate. The Department is concerned not only about collecting the appropriate amount of taxes from these companies, but about helping these companies become successful, profitable tax paying businesses that provide income and employment to the People of West Virginia. It is necessary then that both agencies work together to achieve this desired result.

Third, the total number of companies potentially required to pay Workers Compensation premiums was 48,166 as of September 30, 2005. The total number of active business registrations as of January 2006 was 196,216. Due to the shear volume of businesses registered for tax purposes as opposed to the lesser number of businesses who must pay premiums to the WCC, and due to the dearth of human resources within the Tax Department, the Department would have great difficulty in implementing a policy of revocation that mirrors the WCC approach.

Finally, the Department is concerned about the 14.3% of companies that did not comply with the WCC and allowed their license to be revoked. The actual number of these companies totals 631. While the Legislative Auditor discloses that several were already

6

out of business at the time of revocation, it is presumed that a significant number were still engaged in business. The responsibility for enforcement of these business registration certificate revocations has not devolved upon the WCC or the Insurance Commission, but has instead become a responsibility of the West Virginia State Tax Department. Should the Tax Department adopt an approach similar to the WCC in revoking business registration certificates, the enforcement dilemma will intensify exponentially.

The Tax Department acknowledges that serving notices of business license revocations on a wholesale basis to delinquent taxpayers could generate some undetermined amount of revenue for the State. However, unlike the WCC or the Insurance Commission, this Department must be prepared to enforce the revocation of business registration certificates. Given our current limited resources, enforcement actions against a significant number of businesses operating without a license would be extremely difficult. For the reasons stated above, the Tax Department believes it is more appropriate to pursue the revocation of business registration certificates sparingly against only the most egregious cases where a taxpayer has repeatedly demonstrated their refusal to fulfill their state tax obligations. The Tax Department believes the net revenue yield from a business registration certificate revocation program would be relatively small, and would be particularly small if the Tax Department is forced to redirect currently productive human and fiscal resources into a less productive business registration certificate revocation process.

Maryland's Refusal-to-Renew Policy Reaps Noteworthy Results

The Legislative Auditor reports that in 2003 the Maryland Legislature incorporated a refusal-to-renew provision into statutes dealing with occupational and professional licensing. The provision requires most licensing agencies and boards to obtain clearance each year from the Office of the Comptroller before renewing an occupational or professional license.

Jeff Oakes, Director of the Tax Department's Compliance Division spoke with the Maryland Assistant Attorney General regarding the refusal-to-renewal provision and confirmed that the provision pertains to the renewal of occupational and professional licenses, not business registration certificates.

This practice has been implemented in other states as well. The Tax Department recognizes that this could be an effective deterrent against the accumulation of tax debt by certain individuals.

The implementation of this policy within West Virginia would require the adoption of statute by the West Virginia Legislature.

We note that a program of occupational and professional license revocations is significantly different in detail and scope from a wholesale business registration certificate revocation program as proposed by the Legislative Auditor and discussed above.

7

The Effects of the Tax Department's Leniency Are Significant

The Legislative Auditor states "The Tax Department's current belief that threatening revocation will result in closing a business and collecting no revenue is born from a long practice of allowing companies to accrue large unpaid tax liabilities that are difficult to impossible to pay. The Tax Department must intervene sooner to avoid unmanageable delinquencies that will result in no collection of revenue when it informs companies of revocations to the refusal to renew business licenses".

The Tax Department agrees that there is an unacceptable lag time from the creation of a tax liability and the time the Compliance Division receives the tax account for collection. Currently, 9 to 12 months can lapse from the time a liability is incurred before a revenue agent receives the item. This situation is almost entirely attributable to a lack of the technology required to operate efficiently as a modern tax agency.

Our current accounts receivable systems are approximately 30 years old. They provide absolutely no automated case management support. As a result of these deficiencies, the Compliance Division has implemented many standalone computer programs to assist in case management. However, these systems are primitive, and do not interface with the mainframe accounts receivable systems. As much as 50% of revenue agents' time is spent reconciling the information contained in the various systems and manually performing clerical tasks that can be automated in a modern tax system.

The Tax Department realized many years go the need for a more efficient tax system, one that can effectively serve the large number of registered businesses and that can greatly improve the Department's response time to delinquencies. Once implemented, the integrated tax system will provide, among others, the following benefits:

1) The integrated tax system will greatly improve the response time to a tax delinquency. The Department will have the capability to notify taxpayers of their failure to file required tax returns within days of occurrence rather than 6 months after the fact.
2) The integrated tax system is capable of issuing estimated assessments to taxpayers who have failed to file all required tax returns. Currently this enforcement action must be manually performed and, although aggressively used, is very time consuming.
3) The integrated tax system will establish collection cases and assign those cases to revenue agents for action as much as 75% faster than the current accounts receivable systems.
4) The integrated tax system will assign a risk score to delinquent accounts to assist the Department in prioritizing collection efforts.
5) All tax information will be contained within one system, eliminating the tremendous amount of time expended by revenue agents in compiling information contained in multiple systems. Ideally, agents will be allowed to focus almost entirely on collection efforts.

8

These system enhancements will allow the Department to minimize the loss of revenue to the state and will greatly assist in the promotion of voluntary compliance among the taxpayers of West Virginia. Taxpayers will notice our improved efficiency and will respond accordingly. While there will still be those taxpayers with whom the Department will need to pursue enforcement actions, the benefit of improved voluntary compliance will reduce the need to take extreme actions against many businesses, such as the revocation of their businesses registration certificate.

The Tax Department Should Take a Tougher Stand on the Non-Payment of Trust Fund Taxes

The Legislative Auditor has determined that "the majority of delinquent business taxes are consumer sales and wage withholding taxes. These are considered trust taxes because they are collected and held in trust for the State of West Virginia (WVC §11-10-5j). The consumer sales and wage withholding taxes that are imposed and collected by companies represent tax liabilities of other individuals. By law, a person who fails to account for and pay to the Tax Department the amount collected of another person's tax liability is guilty of a felony if the amount of unpaid tax is $1,000.00 or more and has not been paid and accounted for more that 30 days after the due date. (WVC §11-9-5)"

The Tax Department has always considered the failure to pay over a trust fund tax to be a very serious matter, and aggressively pursues responsible officers of delinquent corporations and organizations through the issuance of officer assessments and jeopardy officer assessments. While not always effective, this practice has resulted in the collection of a significant amount of tax dollars due the State, and has brought a multitude of taxpayers into compliance with their filing responsibilities.

The Department understands that most businesses and individuals truly want to meet their tax obligations. Not every sole-proprietor, partner or responsible officer who fails to pay over a trust fund tax intents to "steal" from the State of West Virginia. Many businesses that owe trust fund liabilities have experienced financial and business reverses or a financial hardship resulting in an often temporary inability to pay, and have used tax dollars as operating cash while fully intending to pay the State back the money that they owe. The Department in no way endorses this practice, and financial hardship does not relieve an individual from potential criminal prosecution. However, the Department asserts that in most cases, working with the taxpayer to satisfy the taxpayer's trust fund liability provides the greatest long-term economic and monetary benefit to the State. Therefore the Department uses criminal prosecution very sparingly, only in cases where there is a documented criminal intent to evade the tax. Likewise, the Tax Department proposes to use the authority to revoke a business registration certificate sparingly, and in the most egregious cases, after all other efforts to bring the business into compliance have failed

Payment Plans Should Be Centralized

The Tax Department utilizes a stand-alone computer program called Thumbtax to manage payment agreements. The program is maintained in the Compliance Division headquarters. Revenue agents in both the Division headquarters and all eleven regional and satellite offices are authorized and encouraged to enter into payment agreements with taxpayers who are unable to immediately satisfy their delinquent tax liability.

The Legislative Auditor, in the course of reviewing certain tax accounts, requested payment plan information from the Compliance Division Headquarters. The Auditor takes issue with the fact that certain information had to be obtained from regional offices and was not contained within the automated payment plan program, Thumbtax.

In 2005 the Compliance Division's current Director discovered that not all regional offices were utilizing the Thumbtax payment plan system and implemented a comprehensive payment plan policy, requiring all revenue agents in both the Headquarters and all regional offices to utilize the Thumbtax payment plan system to manage their payment plans.

While the Thumbtax payment plan program is effective in managing payment agreements, it is still a standalone program that does not interface with the Department's accounts receivable systems. Since the accounts receivable system and the payment plan program are not integrated, it is difficult for managers to ensure that revenue agents have utilized the Thumbtax system to manage their payment plans in all cases, even though they have been directed to do so. This problem will be corrected with implementation of the integrated tax system. The integrated tax system will replace the standalone Thumbtax payment plan system and will allow managers to monitor the payment plans of all revenue agents, ensuring they have been properly established.

Conclusions

Given the existing limitations in technological, human and fiscal resources and the multitude of manual processes with which the Compliance Division is encumbered, the Division is extraordinarily efficient in collecting delinquent taxes that, without Division efforts, would remain uncollected. Again, the thirty-three Revenue Agents of the Division have added approximately one half a billion dollars to State coffers for the calendar years 2000 through 2005, with average deposits of eighty-nine million dollars per year for the period.

The Legislative Auditor contends that a significant amount of tax revenue has been allowed to accrue because the Tax Department does not adequately minimize the amount of debt that delinquent businesses accrue. It is further contended that there is considerable lag time between the creation of a delinquency and the Department's response to the delinquency. Finally, the Legislative Auditor contends that, while the Tax Department does well in collecting delinquent tax liabilities overall, the Department's most effective tool in minimizing the loss of revenue is the authority to refuse to renew or revoke a business registration certificate. The Tax Department respectfully disagrees. Over the spectrum of tax compliance options available, business registration certificate revocation is simply not a productive enforcement tool.

The Tax Department long ago recognized the need for a more efficient tax system. The Governor and the Legislature addressed this need in 2005 and appropriated 22 million

10

dollars for acquisition of a new integrated tax system. Once this system is implemented, the Department's response time to a tax delinquency or liability will be greatly improved. This improvement in efficiency will not go unnoticed by the taxpayers of West Virginia, and voluntary compliance with state tax laws will improve accordingly.

In light of their findings, the Legislative Auditor recommends that:

1) The Tax Department utilize the authority granted in §11-12-5 of the WV Code as an enforcement tool,
2) Promulgate rules for applying §11-12-5 of the WV Code
3) The Tax Department establishes policy and procedures to make renewal of business registration certificates contingent upon if a company's account is in good standing with the Department.
4) The Legislative Auditor recommends that the Tax Department discontinue the practice of allowing payment plans to be established at regional offices and all payment plans centralized.

The Department agrees that in the most egregious cases of willful taxpayer non-compliance, the authority to revoke a business registration certificate should be considered. Procedures for applying §11-12-5 of the WV Code have been drafted to guide the Department's actions in this regard and will be implemented.

However, the Tax Department disagrees with the Legislative Auditor that policy and procedures should be established to renew a business registration certificate only to taxpayers in good standing.

First, the Department does not currently posses the technological or human resources to undertake this task, which will affect countless thousands of West Virginia businesses.

Second, non-renewal of business registration certificates is a comparatively ineffective tax compliance procedure. It is in the best interest of the State to address delinquencies and tax liabilities more effectively and efficiently and to communicate our commitment to working with the West Virginia business community in achieving good standing. Engaging in the wholesale refusal to renew business registration certificates in each and every case where a business has a tax deficiency is simply not an effective way to address tax compliance.

Sincerely,

Virgil T. Helton
Acting Tax Commissioner
West Virginia State Tax Department

11