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LEGISLATIVE AUDITOR'S LETTER REPORT

November 19, 2019

Improving the State's Method for Ensuring the Payment of Local Taxes Resulting from State Contracts

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GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS STATEMENT

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards (**GAGAS**). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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November 19, 2019

The Honorable Mitch Carmichael, President
West Virginia State Senate
Post Audits Subcommittee, Co-Chair
Room 229 M, Building 1
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Charleston, WV 25305

The Honorable Roger Hanshaw, Speaker
West Virginia House of Delegates
Post Audits Subcommittee, Co-Chair
Room 228 M, Building 1
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Charleston, WV 25305

Mr. President and Mr. Speaker:

In a December 2017 Post Audit Division report, the Legislative Auditor highlighted an issue concerning subcontractors working through state contracted vendors that were not properly registered with the local government or municipality in which the work was being performed. As a result, cities are unable to collect the taxes owed for the work being performed in their area. This report underscored the fact that the primary cause for cities' inability to collect taxes owed for projects under state contract is that they were unaware of the contract itself or that the contractor or subcontractor was performing this work in their area. To the best of the Legislative Auditor's knowledge neither the agency through which the contract is executed, nor the Purchasing Division, is required to notify the municipalities of the contract after it is awarded. The December 2017 Post Audit Division report resulted in the State Purchasing Division's General Terms and Conditions being modified to require contractors to inform all subcontractors to register with the local governments and municipalities where they are performing work. This addition to the Terms and Conditions section of state contracts is meant to better protect the cities of West Virginia and ensure that all local taxes owed are properly remitted. As a follow up, the Legislative Auditor sought to determine if there was a way to further address this issue and provide greater assurance that the taxes owed to the cities are properly paid.

The fiscal impact of nonpayment of taxes to municipalities due from state contracts could be significant. Based on information obtained from the West Virginia Municipal League, there are 230

municipalities in West Virginia, with 161 who impose a B&O tax. According to the 2018 Annual Report issued by the Purchasing Division, in Fiscal Year 2018 there were 22,065 new contract award transactions and delivery orders totaling approximately \$490 million¹, with an average contract value of \$175,511. WV vendors received approximately 54 percent of the total number of new purchasing award transactions in fiscal year 2018, however, out of state vendors² represented the bulk of the total financial value totaling approximately \$364 million. While the B&O tax rates are unique to each municipality, the general tax rate in WV is approximately 2% of the gross value of the contract. Based on the average contract award and this approximate rate, the potential B&O taxes due would have been approximately \$3,510 per contract awarded. A conservative estimate of the B&O taxes potentially due from all state contracts in 2018, assuming 50% of those contracts are subject to B&O tax at a rate of 2%, would have totaled approximately \$4.9 million.

As previously mentioned, when a state contract is executed neither the agency nor the Purchasing Division is responsible for informing the city of the contract or the work to be performed in the area. Therefore, contractors and subcontractors independently registering with or notifying a city is the only mechanism by which cities are made aware work through a state contract is being done. However, the current mechanism does not provide any assurance that the contractors and subcontractors will comply with the requirement, and there is no direct oversight or verification that this occurs. To remedy this issue, the Legislative Auditor believes that the agency executing the contract, which is aware of the work to be performed and where it will be performed, should be required to provide formal notice to the municipality where Business and Occupation taxes (B&O taxes) are applicable. Given that municipalities and political subdivisions of the State are created to fulfill obligations to the citizens of West Virginia, and are not party to the contract, it is the opinion of the Legislative Auditor that the entities contracting on behalf of the State have a fiduciary duty to notify those municipalities that work through a state contract is being performed.

To provide further assurance that these taxes due are properly remitted to the municipalities, the Legislative Auditor sought to determine if other states had any additional assurance mechanism, beyond the contract terms and applicable laws and recommendations, to ensure the proper payment of all taxes owed resulting from state contracts. Currently, vendors who secure a contract with a state spending unit are responsible for adhering to the laws and regulations of West Virginia, including paying all applicable federal, state and local taxes. While this language is included in the terms of the contract, there is no assurance mechanism to guarantee compliance with this requirement. Neither the agency executing the contract, nor the Purchasing Division, perform any oversight to determine if compliance with this requirement has occurred. As previously noted, the issue that has been reported in the past is that many cities are not aware of state contracts for projects in their area which inhibits their ability to ensure they are collecting city taxes. There could be several reasons for this lack of awareness, the most obvious of which is the cities are not a party to the contract. Also, smaller cities may lack the resources to monitor state contracts and pursue collections against contractors. Additionally, there are currently 46 known exemptions from the Purchasing Division granted to 28 spending units creating multiple avenues for statewide contracts to be awarded and completed without local municipalities becoming aware.

Due to the legal requirement to pay local taxes as a result of state contracts without a mechanism to ensure that these local taxes are paid, the Legislative Auditor surveyed the 49 other states to determine their methods to ensure local taxes owed from state contracts are paid.

¹See Appendix A for a complete breakdown of the 22,065 awards by procurement type, and for the top agencies by volume.

² Vendor location based upon ordering address selected by procurement officer on the award document

The Legislative Auditor was able to determine the assurance mechanism for 38 states. The remaining 11 states did not provide information for this analysis. The states surveyed include:

- Alabama
- Alaska
- Arizona
- Arkansas
- Colorado
- Connecticut
- Delaware
- Florida
- Georgia
- Hawaii
- Idaho
- Illinois
- Iowa
- Kansas
- Kentucky
- Louisiana
- Maine
- Maryland
- Massachusetts
- Michigan
- Minnesota
- Mississippi
- Montana
- Nebraska
- New Mexico
- New York
- North Carolina
- Ohio
- Oregon
- Pennsylvania
- Rhode Island
- South Dakota
- Texas
- Utah
- Vermont
- Washington
- Wisconsin
- Wyoming

Nineteen of the states surveyed address the issue of local taxes owed as a result of state contracts in some way. Of these:

- 14 states have at least one form of assurance mechanism to ensure taxes owed as a result of a contract with the state are paid in full to local municipalities and counties.
 - 4 of those 14 states utilize surety bonds as the assurance mechanism.
- Similar to West Virginia, the remaining five states that do not specifically address this issue simply require adherence to all laws regarding local taxes but lack any assurance mechanism.

The assurance mechanisms utilized by the 14 states include:

- **Retainage** - where the state purchasing office keeps a predetermined percentage of the payment due to the contractor to cover potential debts owed by the contractor during the term of the project. The disadvantage to this mechanism is the negative impact to smaller contractors that operate with smaller profit margins and depend on each full paycheck to operate. Additionally, contractors that utilize subcontractors could potentially abuse this arrangement by offloading the burden of the retainage to the subcontractors, thus decreasing the impact of noncompliance by the contractor and increasing the compliance burden on subcontractors.
- **Withholding payment** – where the state purchasing office holds the final payment from the contractor until it has been made certain that the contractor has no debts owed to the state or municipalities within the state. The disadvantage to this mechanism is it takes a very high level of communication and coordination between multiple state agencies and each of the municipalities where the work was completed. This mechanism could result in increased cost to the State, and potentially municipalities, through the need to increase staff to monitor and process these transactions. Additionally, this mechanism could cause burdensome delays to contractors and subcontractors as they wait on the processing of the final payments through the increased bureaucracy.
- **Deferred payment** – where the state purchasing office begins making payments at some specified time in the future to ensure that the contractor is paying taxes and adhering to the terms of the contract. This mechanism of ensuring compliance potentially faces issues like those discussed

above when withholding payments, including increased staff, bureaucracy, and payment delays. The issues with the deferred payment mechanism result from the need to monitor the contractor and the terms of the contract to ensure that the contractor is being faithful to the contractual obligations on an ongoing basis prior to authorizing each payment. While there are resources available to track contract compliance and taxes, including software, these resources would only stress the budgets of already cash strapped municipalities in the short term until the long-term benefits are realized. In Hawaii a compliance tracker called the Hawaii Compliance Express was developed and implemented in house. Since the system was developed and implemented in house there were no costs to the state other than the salary of the system developers who were already employed by the State.

- **Offset** – where the state purchasing office is made aware of a delinquency owed to the state from a previous contract, and subtracts the amount owed from the current contract payments. This works and ensures the state/municipality receives the money that is owed to them from taxes, but if a contractor is aware of this, they will potentially not pursue a contract in the state again. Also, this allows the contractor to get full payment for the contract and only punishes them when they try to win another contract in the state.
- **Termination of Contract** – where the state purchasing office has the option to terminate the contract if the contractor fails to comply with all terms set forth in the contract between the state and the contractor. This mechanism requires constant monitoring of the contractor and the terms of the contract, which can be costly and time consuming especially for the municipalities that already struggle with funding and the ability to track who is performing work in their area. Additionally, this mechanism is extremely reactive in nature and places the burden of noncompliance on the contracting entity rather than on the contracting vendor.
- **Surety Bond** – where the state purchasing office has the contractor obtain a surety bond, in which the surety financially guarantees to the State that the contractor will act in accordance with the terms established by the bond. If the claim is valid, the insurance company will pay reparation that cannot exceed the bond amount. This transfers the risk of noncompliance from the contracting entity to the contractor and bond issuing entity.

The following table provides a summary of the assurance mechanism utilized by the 14 states that address the issue of local taxes on state contracts:

| Assurance Mechanism | State(s) |
|--------------------------------------|--------------------|
| Surety Bond | AL, NM, SD, WY |
| Retainage/Withholding Payment | AZ, MI, MN |
| Offset | HI, KS, PA, OR, WI |
| Deferred Payment | MD |
| Termination of Contract | OH |

West Virginia Lacks a Mechanism to Ensure Vendors Pay Local Taxes Due in State Contracts

While West Virginia lacks an assurance mechanism to guarantee local taxes due on state contracts are paid, the Legislative Auditor notes that three of the 14 states with an assurance mechanism to ensure that local taxes are paid are states bordering West Virginia: Maryland, Ohio, and Pennsylvania. Kentucky only ensures the payment of sales and use tax to the state. The nonpayment of local taxes is generally more of an issue with out of state vendors due to not being physically located in the area in which local taxes may be owed and the differing tax laws in each state. Contractors may

not intentionally fail to meet all the required tax obligations but may lack the ability to keep up with the differing tax requirements in the different states in which they do business due to the dissimilar rules and requirements.

In our review of the mechanisms employed by other states, Alabama recognizes this potential discrepancy and requires a surety bond for all out of state vendors, while not placing the same requirement on in state vendors. There are two issues with solely requiring a bond for an out of state vendor. First, this would only provide assurance that out of state vendors are held responsible for the payment of local taxes while assuming local vendors will willingly comply. Secondly, it increases the likelihood of human error in the contracting phase by creating two different sets of parameters that would need to be followed for in state versus out of state contractors.

The current mechanism to encourage contractors to pay the required taxes due to the State, which is applicable to all vendors, is the potential debarment of the vendor. Currently under West Virginia Code, a vendor can be debarred for several reasons. One of those reasons applicable to this report is if the vendor is in default on obligations owed to the State. A vendor is considered in default when the vendor fails to submit a required payment, interest thereon, or penalty, and has not entered into a repayment agreement with the appropriate agency of the State or has entered into a repayment agreement but does not remain in compliance with its obligations under the repayment agreement.

The debarment procedures under West Virginia Code §5A-3-33e stipulate that a vendor cannot perform work for the State for a period determined by the Director of Purchasing. The debarment period must be for a period that the Director finds necessary and proper to protect the public from an irresponsible vendor. As set forth by West Virginia Code §5A-3-33f, the debarment period may be reduced by the Director of the Purchasing Division if the vendor eliminates the cause for which they were debarred. Therefore, if a vendor was debarred due to delinquent state taxes and those taxes were subsequently paid, a vendor could be reinstated and be eligible to contract with the State.

While debarment is a mechanism to encourage the payment of delinquent state taxes, it neither guarantees the payment of delinquent taxes to the state, nor does it encompass delinquent local taxes. Since West Virginia Code §5A-3-33d does not specifically include delinquent local taxes as grounds for debarment, a contractor could potentially be awarded state contracts while still having delinquent local tax accounts. While the debarment procedure provides an avenue for the State to encourage payment of the debts, it lacks the guarantee of payment that would be available with a surety bond, and the financial risk of nonpayment remains the burden of the State and local governments.

Currently, vendors contracting with the State are already required to secure various bonds as part of their contractual obligations. This includes bonds for bids, labor, maintenance, and performance. These bonds serve as financial guarantees that the vendor will meet its obligations under the State contract. Many vendors are already familiar with and capable of meeting these bonding requirements as they are not specific to State contracts as they are typically required with contracts in the private sector as well.

In conclusion, strengthening the State's mechanism to ensure local taxes are paid by vendors performing projects under State contracts is in the best interest of the State. The most important issues identified in our review is the fact that the municipalities are not party to the contract and therefore may be unaware that taxes are due as a result of a state contract. Ensuring that these entities are duly notified of these contracts will help improve the collection of those taxes. In furthering the assurance that those taxes are properly remitted, the Legislative Auditor recognizes there are multiple ways to accomplish this goal; however, a surety bond for local taxes would be the least cumbersome option for the State to incorporate into the purchasing process, while also removing the financial burden of noncompliance from the State and local governments. Since there are already established bonding

requirements that a vendor contracting with the State must comply with, it is the opinion of the Legislative Auditor that the additional requirement to obtain a surety bond to ensure the payment of taxes owed as the result of a State contract is the most efficient assurance mechanism option available to the State to address this issue. While this may be burdensome for smaller contractors, this recommendation can be applied in a practical manner using a predetermined threshold that would trigger the requirement, such as imposing this requirement for state contracts that exceed \$1 million in value or greater.

Recommendations

1. The Legislative Auditor recommends the Legislature consider requiring all state spending units executing contracts for state projects to identify and provide formal written notice of the contract and the scope of the work to the municipalities where the work will be performed to ensure payment of all applicable local taxes. This recommendation should apply to all spending units, including those exempted from the Purchasing Division requirements.
2. The Legislative Auditor recommends the Legislature consider establishing a requirement that a surety bond be required for state contracts with a value exceeding \$1 million specifically to ensure the payment of taxes owed to municipalities resulting from state contracts. This recommendation should apply to all spending units, including those exempted from the Purchasing Division requirements.

Respectfully Submitted,



Justin Robinson