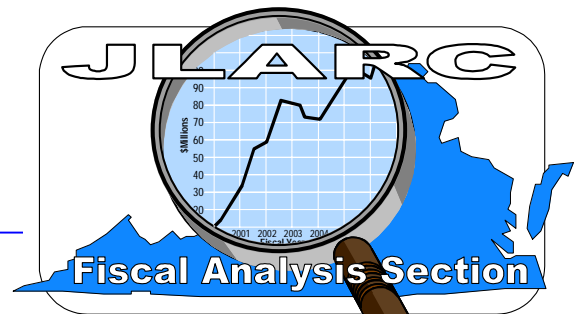


Special Report: Tax Compliance



Summary

The Department of Taxation's efforts to maintain and improve tax compliance have been strengthened since the 1992 JLARC report. The partnership with American Management Systems (AMS) has been a key component, enhancing the agency's ability to identify and pursue potential compliance issues. Three additional actions taken together would further enhance Virginia's efforts to ensure that all taxpayers pay what they owe. These three actions are a tax amnesty, adding compliance staff to the department, and bolstering penalties for failing to file a tax return and filing a false return.

Ten states are offering tax amnesties in 2002, and Virginia offered a tax amnesty in 1990, generating \$32.2 million. The earlier Virginia amnesty waived penalties for delinquent taxpayers who paid their past-due taxes during a 60-day period. It also preceded a series of compliance initiatives, such as establishment of the enforcement unit within the department. An amnesty would provide taxpayers a "last chance" to pay delinquent taxes and fees prior to increased penalties and enforcement.

An important step in bolstering tax compliance should be to authorize the department to employ additional audit and investigative staff. The number of tax audit staff has declined 30 percent since FY 1995, from 236 to 164 auditors. The number of tax returns filed with the department has increased more than ten percent since FY 1995, to 3.17 million in 2002. The total individual income tax collections increased 67 percent from \$4.0 billion in 1995 to an estimated \$6.7 billion in 2002. Additional auditors could help ensure a fair system of tax compliance and improve collections. The criminal investigation unit currently has five staff members and lacks important access to criminal records. Even with the improved productivity under the AMS partnership, additional staff and expanded authority could further enhance compliance and generate additional revenue.

Finally, an enhancement should be considered to the penalty for willful failure or refusal to file an income tax return and for filing a false return, which currently are Class 1 misdemeanors. This is also the penalty for petit larceny, defined as the theft of less than \$200 worth of property. According to department staff, this misdemeanor penalty has inhibited the agency's enforcement efforts. Because the average annual personal as well as corporate income tax liability exceeds \$2,350, the General Assembly may wish to consider assigning a felony penalty to willful failure or refusal to file tax returns, and to filing a false return. These steps could promote a more equitable system and generate additional revenue for the Commonwealth, based on what is already owed under existing tax policies.

2002
October

BACKGROUND

In 1992, the Joint Legislative Audit and Review Commission (JLARC) issued a report that examined the organization, management, and operations of the Virginia Department of Taxation. As part of a review in 2002 of prior reports on aspects of State spending, JLARC asked staff to examine the effectiveness and efficiency of the State tax collection process. Within this broad mandate, the Commission identified several specific requests for staff follow-up:

- to consider the pros and cons of a tax amnesty program,
- to assess the effectiveness of the set-off debt collection requirements and administration (this initiative derived from a earlier JLARC report), and
- to determine whether there is a statutory barrier to requiring taxpayers to mail or file their income tax returns directly with the Department of Taxation instead of encouraging that the returns be sent to local commissioners of revenue.

This paper summarizes JLARC staff findings and recommendations. To carry out this review, JLARC staff met with staff of the Department of Taxation, collected and reviewed various data concerning agency activities, and contacted several other states and national organizations.

TAX COMPLIANCE OVERVIEW

JLARC directed staff to review Virginia's tax compliance efforts in response to several factors. A basic concern is the prospect of declining general fund revenue growth. General fund revenues declined 3.9 percent in Fiscal Year (FY) 2002, and forecasted growth is less than one percent for FY 2003. A recent upward trend in the Virginia Department of Taxation's accounts receivable is also of concern. As recently as FYs 1998 and 1999 the department's receivables deemed "collectible" were decreasing, reaching \$112.3 million in FY 1999. By March 2002, however, they had climbed to \$146.1 million, reflecting a sharp upward trend. The gross amount of receivables for the Taxation Department was \$967.3 million in March, 2002.

An additional factor stems from recent action of the General Assembly to de-conform the Virginia tax code from the federal tax code. Virginia had been a "conforming" state since the early 1970s. Concern that continued conformity could mean reduced State revenues led the 2002 General Assembly to temporarily suspend conformity, with the intention (as noted in §3-5.06 of the Appropriation Act) of reconsidering the matter at the 2003 Session.

Further concerns stem from recent reports by the Commissioner of the Internal Revenue Service (IRS) and the General Accounting Office (GAO), indicat-

ing that tax evasion is on the increase. For example, the IRS Commissioner recently estimated that \$207 billion in federal taxes go unpaid each year. In a May 2002 report the GAO noted that an increasing gap between tax compliance and the capacity of the IRS to collect taxes has led the agency to defer collection action on billions of dollars in tax delinquencies. A 1992 JLARC report on the Virginia Department of Taxation estimated Virginia's "tax gap" (the difference between what is collected and what is actually owed by taxpayers) at more than \$512 million.

In response to the 1992 JLARC report, the department has taken a number of steps to improve both compliance and collections. These include making better use of agency data for compliance purposes and undertaking a multi-year partnership with a private sector vendor to upgrade agency computer systems. Some barriers to improved tax compliance remain, however.

Actions Taken to Improve Compliance

One important step in enhancing revenue collection was the department's multi-year contract with American Management Systems (AMS), a private sector information management firm, to upgrade the department's information systems. A key feature of this contractual relationship was that AMS would be paid exclusively from new revenues generated as a consequence of the newly developed and installed information systems; no direct appropriation was made for the partnership. This arrangement was authorized by 1996 legislation (*Code of Virginia §58.1-202.2*) and by language in the Appropriation Act. The department's contract, signed in 1998, has resulted in payments to AMS totaling \$81.7 million for the four years ending FY 2002.

According to the Taxation Department, the partnership with AMS has generated new revenue above and beyond what the department would have collected without the partnership. Once the AMS contract is concluded, expected in 2004, continued additional State revenues are expected.

Another improvement in the department's strengthened tax compliance program is better use of available data. Broadly referred to as "data mining," this effort – which predates the AMS partnership's work – attempts to compare tax-collection records with a variety of other data to help identify people and businesses that may not be paying enough taxes. The department uses a variety of computer programs and databases to facilitate this process. An example is a computer program which identifies individuals in Virginia who received a federal informational tax return (such as a W-2 or 1099) and thus probably had income, but did not file either a federal or a State tax return (for tax year 1999 the department identified over 157,000 such individuals). The department can then follow-up with these individuals to determine whether the non-filing was valid.

Steps such as the AMS partnership and data mining are improving the department's ability to enforce tax law and ensure equitable compliance. The de-

partment also began to use outside collection agencies in 1996. These agencies collected \$23.4 million (net of their costs) in FY 2002. There remain several actions that should be considered, however. Virginia currently has a relatively weak penalty for failure to file a tax return, and the number of tax auditors and investigators – although not their performance – has declined in recent years. Together with a brief tax amnesty period, actions in these areas could significantly bolster the Taxation Department’s efforts to increase collections.

Tax Amnesty

Tax amnesty programs have been widely used by states, including Virginia, as a means of helping the general public accept an increase in penalties and enforcement, and as a way to generate revenue. Typically, these programs waive, for a brief period of time (usually 60-90 days) all or a portion of the penalties and interest on any overdue taxes paid during that period. Sometimes these programs also exempt from penalties and interest the payment of debts owed to State agencies and programs. Amnesties offer people a “last chance” to pay delinquent taxes and fees prior to increased penalties and enforcement, and an opportunity for the State to receive revenues that otherwise would either not be collected, or that would be costly to collect.

Forty states have had at least one tax amnesty since 1982, according to the Federation of Tax Administrators. Ten states have had a tax amnesty period in 2002 (including neighboring Kentucky; Maryland had one in 2001). Several states’ tax amnesties have led to payment of more than \$100 million, although the typical amount collected is lower. Virginia’s 1990 tax amnesty program generated \$32.2 million. State tax amnesty programs implemented over the past five years, and their revenue results, are listed in Table 1.

Amnesty programs have varied in several ways, which in turn may affect the amount of revenue generated through the amnesty. Key factors include whether some or all State taxes and fees are selected for amnesty, whether the amnesty applies piecemeal to each delinquent bill presented by a taxpayer or only once per taxpayer, whether all or just some of the penalties and interest due are waived, the length of the amnesty period, the extent of publicity about the amnesty, and whether subsequent penalties are increased – thus enhancing the incentive to pay past-due taxes during the amnesty period.

Virginia’s 1990 Tax Amnesty Program. The 1989 General Assembly adopted bills (HB 1596 and SB 732) that provided a comprehensive amnesty, applicable to all taxes administered by the Department of Taxation. The program provided that all nonfilers and those with assessments outstanding, excluding those under investigation or prosecution for filing a fraudulent return or failing to file with intent to evade the tax, were eligible to participate. In effect, taxpayers were given a chance to voluntarily pay delinquent taxes before enhanced tax enforcement efforts took effect, including increased penalties, establishment of the

Table 1
State Tax Amnesty Programs Since 1997
(\$ in millions)

<u>State</u>	<u>Period</u>	<u>Revenue Collected</u>
Arizona	1/1/02 – 2/18/02	\$ 10 (est.)
Connecticut	9/1/02 – 11/30/02	\$ 24 (est.)
Kentucky	8/1/02 – 9/30/02	\$24-30 (est.)
Louisiana	9/1/01 – 10/30/01	\$ 173.1
Maryland	9/1/01 – 10/30/01	\$ 39.2
Michigan	5/15/02 – 6/30/02	\$ 15.5 (est.)
Missouri	8/1/02 – 10/30/02	\$15-30 (est.)
Nevada	2/1/02 – 6/30/02	\$ 7.3
New Hampshire	12/1/97 – 2/17/98	\$ 13.5
New Jersey	4/15/02 – 6/10/02	\$ 59.6
New Mexico	8/16/99 – 11/12/99	\$ 45
Ohio	10/15/01 – 1/15/02	\$ 48.5
Oklahoma	8/15/02 – 11/15/02	NA
South Carolina	10/15/02 – 11/30/02	NA
South Dakota	4/1/99 – 11/12/99	\$ 0.5
Wisconsin	6/15/98 – 8/14/98	\$ 30.9

Sources: Federation of Tax Administrators' website. Estimates are from legislative fiscal notes and the taxation agencies in the respective states.

criminal investigations unit, and authority for the Tax Commissioner to “padlock” businesses seriously delinquent in paying their taxes.

The 1989 fiscal impact statement on the legislation indicated that approximately \$21.84 million was the “maximum revenue potential” of the tax amnesty, based on data from other states and an analysis of accounts receivable in the department. In fact, \$32.2 million was collected during the amnesty period, which ran from February 1 through March 30, 1990. Of the approximately 27,000 taxpayers who took advantage of the amnesty, 1,249 were new taxpayers added to the rolls (1,245 were individuals, and just four were businesses); the rest were already included in the department’s accounts receivable. These new taxpayers contributed \$3.1 million as a result of the amnesty. The direct cost of administering the overall amnesty, according to the department, was \$1.4 million. This covered publicity, temporary employees, equipment, and computer system modifications. Not included in this cost figure was responding to over 70,000 phone calls and walk-in customer questions.

Potential Yield from a Tax Amnesty. Estimating the dollar yield from a tax amnesty program is difficult for several reasons. There is no clear way to

estimate the number of delinquent taxpayers who will come forward and pay their back taxes in exchange for the inducements offered, such as reduced or waived penalties. The amount owed by each delinquent taxpayer who applies for amnesty is also difficult to estimate. Additionally, an expanded amnesty program could offer reduced penalties for persons owing money to other State agencies. The effect of administrative matters such as whether taxpayers would be permitted to make partial payment or would be required to pay in full all taxes owed, also affects the possible yield of an amnesty. Predicting the number of these persons who would pay if offered amnesty is also difficult.

Keeping these difficulties in mind, there are several ways of estimating the potential yield of a tax amnesty program. Applied to Virginia, these methods generate a potential one-time yield of at least \$51 million (Exhibit 1). There would also be some offsetting costs; as noted, Virginia spent \$1.4 million administering the 1990 amnesty.

Exhibit 1

A Tax Amnesty Could Generate Additional Revenue

It is difficult to estimate the revenue potential of a tax amnesty. Several approaches yield estimates starting at \$51 million. These estimates make various assumptions about taxpayer behavior and other factors that may or may not be valid. The three principal ways JLARC staff estimated the yield are as follows.

Per capita Virginia collections. One method uses Virginia's 1990 tax amnesty experience, where \$32.2 million was collected, representing \$5.20 collected per capita. Taking into account the 37% inflation that has occurred since 1990, the \$5.20 per capita collected by Virginia in 1990 is equivalent to \$7.12 in 2002 dollars. Multiplying this figure by the estimated population (7,188,000 in 2001) yields a potential for collecting **\$51.2 million** from a similar tax amnesty program.

Per capita collections in other states. A different approach to estimating the potential yield of a tax amnesty program is to take the average per capita actual or an estimated collection for all states listed in Table 1, which was \$9.24 per capita (it should be noted that there was a very wide range in this per capita measure, from \$1.55 in Michigan to \$38.72 in Louisiana). Assuming Virginia's collections would equal this average per capita amount, then – using the 2001 estimated population – Virginia could expect to collect approximately **\$66 million**.

Extent of participation in the 1990 Virginia amnesty. According to the Department of Taxation, 26,844 taxpayers applied for the 1990 Virginia tax amnesty. Of these, 25,600 were already known tax delinquents, amounting to 0.99% of the approximately 2.6 million taxpayers who filed a return in 1990. Assuming a similar percentage of current taxpayers would apply for amnesty, an estimated 33,400 would apply. The 25,600 applicants in 1990 made amnesty payments averaging \$1,125, or \$1,541 in inflation-adjusted dollars. If 33,400 applicants averaged \$1,541 in amnesty payments, the yield from known tax delinquents would total **\$51.5 million**.

Source: JLARC staff analysis.

Pros and Cons. Several factors should be considered prior to adopting a tax amnesty program. There are costs as well as benefits to the program, and there are also policy-based concerns.

As the 1990 Virginia tax amnesty demonstrated, amnesties are probably more effective at reaching known delinquent taxpayers than at finding unknown tax evaders. The benefits of a tax amnesty program are primarily in the form of one-time payments that may not have been made without the amnesty, or that would have been collected only after a relatively expensive compliance and enforcement effort. The key benefit is that these revenues are accelerated into a given year. The benefits may continue because, having applied for amnesty, a taxpayer may be motivated to subsequently file regularly because the taxpayer knows they have been “noticed” as a previous non-filer and delinquent.

One concern with a tax amnesty program is that it appears to excuse or overlook failure to file tax returns and failure to comply with the tax law. Taxpayers may think that they can fail to pay their taxes and just wait for the next amnesty. This undercuts the voluntary nature of the tax system.

This concern can be addressed partially by rarely offering amnesty (in Virginia’s case, it has been 12 years since the last and only amnesty period), and by not totally eliminating the penalties or interest delinquent taxpayers must pay. The infrequent offering of amnesty would also help keep the public from anticipating future amnesties, which could reduce voluntary compliance. Although most state amnesty programs have eliminated all penalties and interest to maximize the incentive effects for delinquent taxpayers, some states merely reduce, not eliminate, penalties. For example, Ohio reduced penalties by 50 percent during its 2001 amnesty period. Connecticut reduced only the interest rate by 25 percent during its tax amnesty period.

Another way to address the concern about excusing noncompliance is by offering the amnesty just prior to an initiative that enhances the overall tax compliance and enforcement effort, as Virginia did in the 1989 legislation. An amnesty can also help the public accept the implementation of enhanced penalties. Some states (notably Kentucky) imposed a 20 percent penalty (on top of all other penalties and interest) on taxpayers who ignore the amnesty and are subsequently caught. In this fashion, taxpayers have an incentive to pay taxes before enhanced penalties and other consequences are levied.

Another concern about tax amnesty is that the amounts owed by delinquent taxpayers would be collected at some point anyway, through routine enforcement and compliance efforts. These later payments may also include penalties and interest, thus increasing the amount collected. One response to this concern is that amnesty programs are designed to collect past-due taxes in a specific period of time, encouraging the payment of the taxes owed during a specified fiscal year. In addition, these overdue tax payments may or may not be collected through a tax agency’s routine audit and compliance efforts, and an am-

nesty can be one way of increasing the likelihood that the past due amounts will in fact be paid.

Compliance and Enforcement Staff

Two staffing concerns came to light during this review. First, the number of auditors has declined. Second, the modest criminal penalty attached to the offenses of failure to file and filing false tax returns hinders enforcement efforts and investigations by the department.

Decline in the Number of Audit Staff. The Department of Taxation has, as noted earlier, taken a number of steps to improve the effectiveness of its compliance staff. Through improved use of automated systems and other means, department staff has increased collections even though their numbers have declined. For example, in FY 1995 (prior to the AMS partnership) the department had 236 field and office auditors, and revenues due to direct enforcement actions taken by the department totaled \$263.4 million. By FY 2002, the number of auditors had declined 31 percent to 164, yet enforcement-related collections increased to \$309.6 million (excluding AMS-related revenue).

The decline in the number of tax auditors coincided with a significant increase in both the number of returns filed and the total tax collections (Table 2). The number of individual income tax returns increased 17 percent to an estimated 3.17 million, for example, between tax year (TY) 1995 and TY 2002. Total individual income tax collections increased 67 percent from \$4.0 billion in TY 1995 to \$6.7 billion in TY 2002. Even with improved productivity resulting from the AMS partnership and other department initiatives, additional audit staff could further enhance compliance and generate additional revenue.

Despite the 31 percent decline in the number of auditors, productivity per auditor (defined as enforcement-related collections per auditor) climbed from \$1.1 million in TY 1995 to \$1.75 million in TY 2002. If the department could have achieved this higher productivity level while utilizing the same number of auditors in 2002 that it had in 1995 (236, or 72 more than the department employed), then an additional \$125 million could perhaps have been collected by the agency. This calculation is merely an illustration of the potential impact of additional audit staff. An alternative method, used by the California Franchise Tax Board, suggests a return of \$4 for every \$1 invested in additional compliance staff. With this method, and an additional investment of \$4.3 million (the approximate annual cost of 72 additional audit staff), a return of about \$17.3 million could be anticipated. The actual amount that additional audit staff could generate would depend upon a variety of factors.

Adding compliance and enforcement staff such as auditors and criminal investigators would provide an important boost to the State's tax enforcement efforts. Collections resulting from direct enforcement actions of the Department of Taxation (excluding revenues due to the AMS partnership) have been flat for the

Table 2
Trends in Department of Taxation Compliance Staffing

	Office & Field Audit Staff*	Income Tax Returns Filed**	Individual Income Tax Collections**	Corporate Income Tax Returns	Sales Tax Dealers
FY 1995	236	2.70	\$4,028.1	131,860	139,032
FY 1996	225	2.74	4,348.0	137,964	140,490
FY 1997	214	2.82	4,727.8	142,613	141,909
FY 1998	199	2.86	5,405.4	148,428	147,775
FY 1999	190	2.95	6,087.9	151,948	142,881
FY 2000	182	3.02	6,828.9	150,536	141,868
FY 2001	179	3.11 (preliminary)	7,226.3	147,085	139,954
FY 2002	164	3.17 (estimated)	6,710.8	N/A	138,706
Percentage Change	-30.5%	+17.4%	+66.6%	+11.5% (FY95-FY01)	(-0.2%)

*Excludes supervisory and clerical personnel.

**In millions NA=data not available.

Source: Department of Taxation.

past four years, averaging \$310 million per year. While maintaining this level of collections is an important accomplishment in light of the declining number of employees dedicated to collections and compliance, adding staff could lead to increased collections.

Criminal Investigators Have Limited Authority. Another step that should be considered is bolstering the authority of the department's criminal investigation unit. This unit, established as a result of legislation in 1989, currently has five employees who investigate allegations of tax fraud. Two important constraints on Tax Department investigators relate to their lack of access to criminal history data, and a cumbersome requirement for handling evidence in criminal tax cases.

One consequence of not having law enforcement staff is that the department is barred from accessing certain criminal history information. Section 19.2-389 of the *Code of Virginia* limits access to the criminal history database maintained by the Department of State Police to certain specified entities. Access to this information would provide the Department of Taxation with the ability to determine, for example, whether persons under investigation for tax fraud also had

outstanding criminal warrants, or prior violent or white-collar convictions. Without this information, the safety of department investigators may be jeopardized, and investigations may be less effective.

Investigators in various other agencies, including the Lottery Department, the Department of Motor Vehicles, the Department of Alcoholic Beverage Control, the Charitable Gaming Commission, and local social services department fraud prevention and investigation units, have the necessary statutory authorization. The Department of Taxation should be authorized to have access to criminal history records for purposes of conducting investigations under the tax laws of Virginia.

Enhanced Penalty for Failure to File a Return

Under current law (*Code of Virginia* §58.1-348), failure to file an individual income tax return by the due date carries a financial penalty of six percent of taxes due for each month past the filing date, up to a maximum of 30 percent in the aggregate. The statute provides that willful failure or refusal to file an income tax return is a Class 1 misdemeanor. Section 58.1-452 applies the same penalty to corporate officers who make a fraudulent return or statement with intent to evade taxes. Willful failure by an employer to make a return or to withhold or pay the tax also carries a Class 1 misdemeanor penalty (section 58.1-485). The maximum penalty for this offense is a fine of up to \$2,500 and up to 12 months in jail.

Staff of the Department of Taxation have indicated that this relatively low penalty hinders effective enforcement of tax laws. The Class 1 misdemeanor penalty is the same as for the crime of petit larceny, which is defined as the theft of less than \$200 worth of property. The penalty appears inappropriately low, in part because the average amount of taxes due far exceeds the \$200 threshold. For example, the average annual personal income tax collected, net of refunds, in 2001 was approximately \$2,350, and the average annual corporate income tax collected was approximately \$2,475.

Criminal penalties in other jurisdictions are mixed. Of Virginia's neighboring states, three (Kentucky, North Carolina, and Tennessee) make failure to file and criminal tax fraud a felony offense, and three make these offenses a misdemeanor (Maryland, West Virginia, and the District of Columbia). Failing to file a federal tax return is classed as a federal felony offense.

Enhancing the maximum penalty for willful failure or refusal to file tax returns could induce more persons to file and provide a more equitable system for those who do voluntarily pay their taxes. Thus it could also increase revenues paid to the State, as well as help offset the costs of collecting revenue.

OTHER FOLLOW-UP TOPICS

The Commission at a July 2002 meeting asked staff to follow-up on several topics from previous JLARC reports. These included the status of the set-off debt collection program, and whether there is a statutory problem in the filing of tax forms. A related matter from a prior JLARC report is the calculation of the “tax gap.”

Set-Off Debt Collection

In response to a JLARC Special Study, the General Assembly in 1982 enacted a procedure for using tax refunds as an automatic offset for any debts owed to the State by taxpayers. Over the years, this program has been expanded to include a wide variety of debts, such as child custody payments, college tuition and fees, court fines and fees, and a wider variety of possible offsets, such as lottery winnings. This program has proven to be quite successful, generating \$29.9 million in revenues for the State and localities in FY 2002. Since the program began in 1983, more than \$282 million has been generated.

The program is available to localities and other public entities for the purpose of collecting fees and payments owed. Of the \$29.9 million collected in FY 2002, \$12.1 million was for debts owed to local agencies. Nearly 800 State and local agencies currently participate in the program.

Filing Income Tax Forms

JLARC members asked staff to identify whether there are statutory or other constraints preventing the Department of Taxation from requiring taxpayers to mail their tax forms directly to the department. In fact, *Code of Virginia §58.1-306* bars the Department of Taxation from promoting or soliciting income tax returns unless requested by a local official. To date, 18 jurisdictions have agreed to allow the Department to solicit directly filed returns by stating that they be mailed directly to the department.

The department has indicated that the statutory language does not pose a problem in this regard. Taxpayers in any jurisdiction may choose to file returns directly with the department either by mail or electronically. *Code of Virginia §58.1-9(C)* authorizes the electronic filing of any state tax return, “notwithstanding any other provision of law.” This applies to any electronic means, including telefile (telephone filing direct with the department), e-File (electronic filing of State taxes and forms with the IRS), and iFile (internet filing direct with the department). For income tax returns filed in 2002 (primarily for tax year 2001), 71 percent of all income tax returns were filed directly with the department, up from 59 percent as recently as FY 1998.

Calculating the Tax Gap

The 1992 JLARC report on the Department of Taxation noted that the U.S. Internal Revenue Service and many state tax departments compute estimates of the difference in what they are collecting and what taxpayers actually owe. These differences are commonly referred to as “tax gap” estimates. The Virginia Department of Taxation had not calculated a tax gap at the time of the report. JLARC staff estimated that the reporting tax gap (the difference in what individual and corporate taxpayers voluntarily report on their returns and the taxes that they actually owed the State) was more than \$512 million in 1992. The department’s accounts receivables, estimated then at \$404 million, were taken as evidence of a cumulative remittance gap (the difference between what taxpayers voluntarily remit and the amount they actually owe). As of March 31, 2002, the department’s gross accounts receivables stood at \$967.3 million, with \$146.1 million estimated to be collectible.

Department staff indicated that they have not estimated the tax gap, preferring instead to focus efforts on specific compliance programs that produce the greatest revenue at the least cost. While the department has made more effective use of third-party databases and other data mining activities, as noted earlier, there have been other developments, such as the proliferation of pass-through entities such as partnerships and other limited liability entities, which have made it difficult for the department to track income and ensure compliance with voluntary reporting. Because measuring progress toward closing the tax gap could be an important indicator of the department’s overall enforcement and compliance activities, the department should provide an estimate of the tax gap in Virginia.

CONCLUSION

Several steps should be taken to bolster Virginia’s tax collection efforts. Taken together and phased so that the amnesty occurs before the enhanced penalty for failure to file takes effect, and coincident with the hiring of additional tax auditors and the completion of the AMS partnership activity, these steps can lead to stronger tax collections. Taken as a package, with an amnesty period prior to beefed-up enforcement, taxpayers should have a strong incentive to settle up. Adequate publicity should be given to this overall effort, to maximize its benefits. Collecting taxes from everyone who already owes them under existing tax policies may help mitigate the need for future tax increases.

Recommendation 1. The General Assembly may wish to authorize a 60-day tax amnesty period. The amnesty may be modeled on the 1990 Virginia amnesty, which provided that all non-filers and those with assessments outstanding (excluding those under investigation or prosecution for filing a fraudulent return or for failing to file) would be eligible for the amnesty. Penalties and interest could be reduced or eliminated during the amnesty period.

Recommendation 2. The General Assembly may wish to make failure to file or willful refusal to file a tax return, and filing a false return, a felony offense. This would require amending *Code of Virginia* §§58.1-348, 58.1-452, and 58.1-485.

Recommendation 3. The General Assembly may wish to authorize the Department of Taxation to employ additional field and office audit staff, and criminal investigative staff.

Recommendation 4. The General Assembly may wish to authorize the Department of Taxation to have access to criminal history records maintained by the Department of State Police, for purposes of conducting investigations under the tax laws of Virginia. This could be implemented by adding the Department of Taxation to the list of agencies with such access included in §19.2-389 of the *Code of Virginia*.

Recommendation 5. Should the prior recommendations be adopted, the Department of Taxation should undertake a significant effort to publicize them. A combination media, internet, and mass mail campaign should be considered.

Recommendation 6. The Department of Taxation should develop a methodology for estimating the tax gap, and report its estimate on a regular basis to the House Finance and Senate Finance committees.



COMMONWEALTH of VIRGINIA
Department of Taxation

October 9, 2002

Mr. Philip A. Leone, Director
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building, Capitol Square Richmond, Virginia 23219

Dear Mr. Leone:

Thank you for the opportunity to review the exposure draft of the JLARC special report on Tax Compliance. On balance, we view the report as complimentary of TAX's efforts to improve Compliance programs over the years and as validation that **TAX** has been responsive to many of JLARC's previous recommendations. With respect to factual corrections, we have noted very few and have transmitted those to your staff by phone.

With respect to written comments, I offer the following observations and ask that they be appended to the report. I also wish to speak to these concerns at the Commission's meeting on Tuesday.

Tax Amnesty

The report suggests that the potential yield from a follow-up amnesty program would be between \$51 million and \$66 million. While a revenue initiative of this size would be tempting in these times, we think amnesty's revenue potential is overstated and the method used in its estimate is oversimplified.

Many states have offered amnesty programs in the last 15 years with varying results. Prevailing wisdom among tax administrators is that amnesty programs should be considered "one-time" opportunities by the public. Only five states with tax structures similar to Virginia's have also conducted follow-up amnesties, as is recommended in the report. Of those five, revenues collected from the follow-up amnesties in four states were approximately equal to or less than the first amnesties (Maryland, New York, Wisconsin, and Kentucky). Only New Jersey conducted a second amnesty that was significantly more successful than its first, primarily because of the second program's better carrot and stick approach and more publicity. These results suggest that the upper limit of revenue available to Virginia would be approximately what it collected in the first amnesty - \$32.2 million.

Even this figure is probably overly optimistic considering the manner in which Virginia and other states have counted amnesty revenue. Neither Virginia nor other states make any attempt to measure revenue lost as a direct result of amnesty programs because of: 1) the diversion of compliance personnel from their normal-revenue producing activities to the amnesty effort; 2) the revenue that would have otherwise been collected in the absence of an amnesty program; 3) the post-amnesty loss in revenue caused by the accelerative nature of amnesty revenue; and 4) the long-term loss in revenue as taxpayers adjust their behavior in anticipation of future amnesties.

These points are borne out in other reviews on amnesty. For example, in a critical audit of New York State's recent amnesty program, the New York State Comptroller showed that the revenue department had significantly overstated amnesty's revenue benefits and concluded, "the Tax Department did not fully account for the revenue that would have been collected even without the Program and the penalties that would have been assessed in the absence of the program." In a 1998 review of amnesties by the Congressional Joint Committee on Taxation, the committee staff estimated that a federal tax amnesty would produce a net revenue loss "primarily because a Federal tax amnesty will have the long-run effect of modestly reducing overall taxpayer compliance with Federal tax laws." The JLARC estimates could not have adjusted for these effects because neither Virginia nor the other states have attempted to measure them in the data they report publicly.

The suggestion that a second amnesty would produce twice Virginia's 1990 results appears to ignore, or at least discount, 1) the positive compliance effect of the original amnesty going forward, and 2) the acknowledged improvement in TAX's compliance effort since the last amnesty. Notably, Maryland's recent second amnesty produced about one-half of what was estimated.

Aside from the revenue estimate, we believe that TAX would be unable to take on the systems development and staffing efforts required to conduct a robust amnesty program and at the same time convert its mission-critical taxpayer accounting system (STARS) to the newly designed Advantage Revenue system scheduled for October 2003. If the General Assembly insisted that TAX conduct an amnesty program during or before this major conversion, TAX would probably have no choice but to defer the conversion and incur the added project costs caused by the delay, perhaps \$15 million or more.

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Compliance and Enforcement Staff

We are flattered by the report's reference to increased productivity of our auditors citing increased revenue despite declining-staff. We also agree that TAX could collect even more revenue with more staff. However, it is unrealistic to expect each additional tax auditor can produce \$1.75 million in added revenue or that 72 more auditors could produce \$125 million.

The revenue potential of added auditors must be computed at the margin not the average. More importantly, the revenue attributed to auditors must also be attributed to a large supporting cast without which the auditors' efforts are compromised. They include: 1) collectors to pursue delinquent audit assessments; 2) customer service representatives to answer incoming calls and correspondence provoked by audit/collection notices; 3) appeals and rulings staff to resolve audit disputes, 4) regulatory staff to clarify tax issues discovered by auditors; 5) IT staff to maintain automated audit/collection tools and data matching programs used in audit selection; and 6) processing staff to handle additional tax returns generated by nonfiler discoveries.

Some states use rule-of-thumb estimates of additional compliance revenue that can be produced from marginal increases in compliance and support staff such as \$4 in revenue from each \$1 in expense. TAX is preparing a detailed estimate of revenue to be gained from additional staff at the request of Secretary of Finance, John M. Bennett.

Measuring the Tax Gap

In 1992 and again in this report, JLARC recommended that TAX undertake an effort to estimate the extent of the tax gap in Virginia. We maintained then and still believe that a tax gap project would not be a good use of the department's resources. Among revenue agencies, the IRS has the most experience at conducting tax gap studies. The common technique is to randomly select a statistically significant group of taxpayers and conduct thorough audits of their income and reported tax liabilities. These studies often require "lifestyle" audits to reconcile a taxpayer's apparent level of affluence with reported income.

These audits are generally regarded as objectionably intrusive, particularly by taxpayers randomly selected without probable cause to indicate noncompliance. As a consequence, tax gap studies can attract significant resentment from the public and opposition from their elected representatives. A tax gap study initiated by the IRS several years ago was cancelled by Congress because of public outrage. A new and less intrusive tax gap study was just announced by the IRS. However, its utility as a predictive tool is yet to be proven.

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TAX believes that tax gap studies are interesting from an academic perspective, but are very expensive to conduct and offer little value in directing a revenue agency's compliance efforts. The largest component of expense derives from the lost opportunity revenue caused by diverting audit staff from candidates chosen for cause in favor of candidates chosen at random. In addition, even if tax gap studies could accurately measure the actual revenue gap, they provide little value in predicting the return on investment potentially gained from the pursuit of a general type of noncompliance whose candidates are still unknown to the revenue authorities.

Instead of randomly selected candidates, TAX prefers to conduct pilot studies of candidates suspected of noncompliance. After audits are analyzed from the pilot studies, and a satisfactory return on investment can be inferred, TAX will upscale these pilots into operational compliance programs. We believe this approach to the tax gap is both cost-effective and more acceptable to the public. We will be alert, however, to any lessons learned by the IRS in its most recent attempt to measure the tax gap.

Conclusion

The revenue numbers in the JLARC staff report on amnesty and additional audit staff are irresistibly attractive. If we felt comfortable with them, we would lead the way on each initiative. We have grave concern, however, that the report may create unrealistic expectations that TAX cannot achieve. We are all the more concerned that such numbers could end up as revenue estimates relied upon to balance the state budget.

With respect to the tax gap, we, too, are curious as to the actual dollar value of the gap. However, we do not believe a tax gap study would be a profitable expenditure of resources that could otherwise be used to collect revenue from proven sources.

I wish to thank the JLARC staff for their professional courtesies and their considerate examination of the current state of our compliance programs. We look forward to working with the General Assembly in fashioning new approaches to developing the Commonwealth's revenue potential.

Sincerely,

Kenneth W. Thorson
Tax Commissioner

c: The Honorable John M. Bennett
Secretary of Finance