STATE OF WEST VIRGINIA

FULL PERFORMANCE EVALUATION OF THE

Department of Tax and Revenue
Internal Auditing Division

The Internal Auditing Division
Recovers Tax Revenue Cost
Effectively But Enhanced
Automation is Needed in Some Areas

OFFICE OF LEGISLATIVE AUDITOR
Performance Evaluation and Research Division
Building 1, Room W-314
State Capitol Complex

CHARLESTON, WEST VIRGINIA 25305
(304) 347-4890

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January 2001

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

January 7, 2001

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

The Honorable Vicki V. Douglas
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 Tax and Revenue*, Internal Auditing Division, which will be presented to the Joint Committee on Government Operations on Sunday, January 7, 2001. The issue covered herein is *"The Internal Auditing Division Recovers Tax Revenue Cost Effectively But Enhanced Automation is Needed in Some Areas."*

We delivered a copy of the report to the Department of Tax and Revenue on December 22, 2000. The Department chose not to provide us a written response.

Let me know if you have any questions.

Sincerely,

John Sylvia

John Sylvia

JS/wsc

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The Internal Auditing Division's mission is to conduct internal audits to verify the accuracy of tax returns and taxes owed the state, collect unpaid tax liabilities identified through internal audits, and expedite refunds due taxpayers. The Division has several units which review business and personal income tax returns. The Legislative Auditor reviewed three of these units: Corporate and Franchise Unit, Special Audits Unit, and the Excise Tax Unit. The Legislative Auditor's review of these units indicates that overall the Division recovers revenues cost effectively. **However, there is a lack of automation in some areas which prevent further revenue recovery.**

The Corporate and Franchise Unit is responsible for conducting internal audits on corporate net income tax and business franchise tax returns, issuing refunds, and recalculating State tax liabilities based on federal audits conducted by the Internal Revenue Service (IRS). Based on selection criteria, the Unit audits only about 5% of annual business tax returns. However, these audits produced an average collection of $1,463,584, and a reduction in refunds averaging nearly $6 million dollars annually. Based on the cost of the Unit to conduct these audits, the revenue benefit is $30 to $70 dollars per dollar in audit expenses over the last three years. Nevertheless, **it is a serious deficiency that 95% of business tax returns do not receive at least a mathematical verification of the tax return.** The Tax Department needs to implement a system in which all business tax returns receive at least a mathematical verification of the tax return.

The scope of the Excise Tax Unit was on the Health Care Provider tax, particularly on the new computer system prototype. Before the implementation of the computer system in February of 1998, Health Care Provider tax auditors were virtually unable to conduct audits due to limited resources available. This new prototype system has made the auditing process more *efficient and effective* which has allowed auditors to conduct audits, thus resulting in higher revenue collection. However, this prototype system has some deficiencies. The system currently cannot report the total amount of revenue generated from the audits conducted. Also, the system is unable to report the total amount of refunds that have been issued.

The focus of the Special Audits Unit was on the Individual Income Tax CP-2000 Underreporter Processing System, and audits based on Federal Revenue Agent Reports (RAR) received from the IRS. **Overall, the process used by this Unit is automated and efficient.** The Unit eliminated a previous backlog in audits. The CP-2000 and the Individual Income Tax RAR have an average collection of $623,120 annually for the last three fiscal years. The Unit has experienced a reduction in revenue recovery primarily because of a reduction in the number of RAR's received from the IRS.

The International Fuel Tax Agreement (IFTA) is an agreement between the 48 contiguous states and the 10 Canadian provinces that facilitates the reporting and payment of state motor carrier fuel use taxes. The fundamental principle of IFTA is to allow interstate motor carriers to report and pay such taxes to a single base jurisdiction, instead of registering with and paying each state in which the motor carriers operate.

According to reviews conducted by the International Fuel Tax Association, **the State's IFTA program operates well and is in compliance with most procedural guidelines established by the Association.** West Virginia has had two compliance reviews and both reviews indicated that the IFTA program was in compliance, with a few exceptions. The Division has already addressed many of the issues identified in the reviews. There presently is no risk of the State losing the authority to collect motor fuel use taxes or the loss of matching federal highway funds.

Recommendation 1:

The Corporate and Franchise Unit should explore methods to provide greater automation for the corporate net income tax return and other business taxes to assist in auditing a greater percentage of returns. Also, the Division should assess its resources to verify if additional revenue recovery can be obtained cost effectively.

Recommendation 2:

The Tax Department should give greater priority towards having modifications made to the Health Care Provider Tax computer system so that it is able to determine the total amount of audit revenue collected and the total amount of refunds issued through audits conducted.

Review Objective, Scope, and Methodology

The Department of Tax and Revenue oversees the Tax Division which is responsible for the administration and enforcement of the State's tax laws. Within the Tax Division are several subdivisions. One these subdivisions is the Internal Auditing Division. This division collects and verifies taxes owed the state, identifies and recovers any unpaid tax liabilities, and expedites refunds due taxpayers. The Division also administers the International Fuel Tax Agreement (IFTA).

Objective

The objective of this review is to examine the Internal Auditing Division's effectiveness and efficiency in identifying and recovery of unpaid tax liabilities. This review also examined the administration of the International Fuel Tax Administration, since the State's ability to collect the Fuel Use tax and receipt of any matching federal highway funds depends on compliance with IFTA.

Scope

The scope of the review focuses on four units within the Internal Auditing Division: the Corporate and Franchise Unit, the Special Audits Unit, the Excise Unit, and the IFTA Unit. One concern was on the cost/benefit of revenue recovered from internal audits. Another focus was on the administration of IFTA to ensure that West Virginia is not at risk of losing the authority to collect the State Fuel Use tax and receive all federal matching funds.

Methodology

This analysis was based on the visual observation of the four units' auditing procedures, personal interviews of staff, the review of procedural manuals and other materials, and output data from each unit. Examination of the auditing selection process criteria and the automation used in the auditing process was conducted. The examination of the IFTA unit was based primarily on evaluation reports by IFTA's Program Compliance Review Committee which evaluated West Virginia's IFTA program in 1997 and in 2000. A report issued by the National Conference of State Legislatures on the federal mandates of IFTA was also reviewed. Every aspect of this review complied with Generally Accepted Auditing Standards.

Issue Area 1: The Internal Auditing Division Recovers Tax Revenue Cost Effectively But Enhanced Automation is Needed in Some Areas.

The Internal Auditing Division's mission is to conduct internal audits to verify the accuracy of tax returns and taxes owed the state, collect unpaid tax liabilities identified through internal audits, and expedite refunds due taxpayers. One goal of the Division is to efficiently recover revenue owed the State because of misstatements made by taxpayers on their tax returns. The Division has several units which review business and personal income tax returns. **The Legislative Auditor's review of some of the major units of the Division indicates that overall the Division recovers revenues cost effectively.** However, there is room for further automation in the Division. This review examined the Corporate & Franchise Unit, Special Audits Unit (Individual Income Tax), Excise Tax Unit (Health Care Provider Tax), and the International Fuel Tax Agreement (IFTA) in the Tax Department's Internal Auditing Division.

Corporate & Franchise Unit

The Corporate and Franchise Unit is responsible for conducting internal audits on corporate net income tax and business franchise tax returns, issuing refunds, and examining Federal Revenue Agent Reports (RAR's) received from the Internal Revenue Service (IRS) to determine if an IRS audit results in a change of the State corporate net income tax liability. The Tax Department does not internally audit a large percentage of corporate returns, and there is a need for greater automation of the corporate returns to enhance the process of auditing corporate returns, such as flagging taxpayer miscalculations, etc. Consequently, the Unit has criteria to determine which corporate returns are to be internally audited. Returns that have refunds, tax credits, payments and estimated payments of $50,000 and above are assigned for an internal audit. An annual average of 6,272 internal audits were conducted through fiscal year's 1998-2000 on corporate net income tax and business franchise tax returns (see Table 1). These audits produced an average collection of $1,463,584, and a reduction in refunds averaging nearly $6 million dollars annually.

Table 1
Corporate Net Income Tax and Business Franchise Tax Return Audit Production

	FY 2000	FY 1999	FY 1998
Corporate Net Income Tax/Bus. Franchise Tax *Audits Conducted*	5,949	6,508	6,360
Corporate Net Income Tax/Bus. Franchise Tax *Audit Collections*	$1,347,182	$1,086,988	$1,956,584
Corporate Net Income Tax/Bus. Franchise Tax *Refund Reductions*	$9,648,029	$4,593,847	$8,148,434
Federal 1120 RAR's *amount collected*	$217,883	$569,106	$780,043
Total Revenue Benefit	$11,213,094	$6,249,941	$10,885,061

From a cost-benefit perspective, the Unit generated approximately $30 to $70 in revenue benefits (including refund reductions) for every dollar spent in expenses during the last three years. Despite the positive cost-benefit, **the Legislative Auditor concludes that there could be additional revenue recovery obtained cost effectively.** In Fiscal Year 2000, the Unit audited 4.8% of the 125,133 corporate net income tax and business franchise returns. In Fiscal Years 1999 and 1998, the Unit audited 5.4% and 4.4% of the returns. A former manager of the Unit was working on a system to enhance the process of auditing corporate returns. This system would require the business tax returns to be keyed into a database and allow the computer to review all returns for mathematical accuracy and other flagging procedures. This would allow all business tax returns to at least go through some form of an internal check. However, this has not materialized and therefore only a small fraction of business tax returns are examined. **It is a significant deficiency for a large number of annual business tax returns to not receive at least an internal mathematical check of the return.** The Tax Department should have in place a system that at least provides a mathematical check on 100% of annual business tax returns.

Furthermore, the Unit has gone through a reduction of full-time auditor positions from 6 to 4 over the last 10 years. Thus, expanding the selection criteria to result in a larger number of audits and a larger amount of revenue recovery is not possible at this time.

Another function for the Corporate and Franchise Unit is to conduct audits on the Federal RAR's. The tax information received from the IRS is on audits conducted on corporations that could change a corporation's taxable income on the its State corporate return. This form is then compared to the West Virginia Corporate Net Income Tax Return for the possibility of taxable income changes. If such changes occurred, then the Unit bills and seeks payment of the tax liability. Table 2 shows the audit production and revenue generated from this informational exchange with the IRS.

Table 2
Federal 1120 RAR Audit Production

	FY 2000	FY 1999	FY 1998
Federal 1120 RAR's *audited*	77	86	286
Federal 1120 RAR's *amount billed*	$422,446	$437,703	$930,710
Federal 1120 RAR's *amount collected*	$217,883	$569,106	$780,043

It is the Tax Department's understanding that the reduction in IRS's production in audits is due to it *transferring* auditing positions to public relation positions. As a result, the State's revenue collections from Federal RAR's has significantly decreased.

Special Audits Unit

The primary study in the Special Audits Unit was on the Individual Income Tax. The first part of the study was on the Individual Income Tax CP-2000 Underreporter Processing System. The CP-2000 is a computer system for processing the underreporter data supplied to Tax Department by the IRS. The system matches the information from the IRS with the taxpayer data from the state returns, and creates the necessary billing segment to generate a liability notice. After the liability notice is generated, the billing information is uploaded into the income tax billing system for further collections efforts and payment processing. The CP-2000 and the Individual Income Tax RAR process have both seen a decline in overall production also due to the lack of audit production by the IRS.

Table 3
Individual Income Tax CP-2000 Underreporter Process

	Number of Billings	Amount Billed	Amount Collected
FY 2000	1,558	$425,654	$204,449
FY 1999	1,802	$424,817	$303,818
FY 1998	3,761	$1,158,697	$499,643
FY 1997	4,576	$975,774	$796,545
FY 1996	11,257	$2,071,096	$1,515,685

The Special Audits Unit also conducts Federal RAR's audits on the individual income tax. These audits consists of adjustments to an individual's tax liability, that should have been reported to West Virginia. These adjustments are then cross-matched with state tax returns to ensure proper accuracy. A review is then conducted to see if the individual has already filed and paid adjustments. If the tax liability has not been paid, then a billing is sent to the taxpayer for amount of tax due as corrected. Table 4 represents the revenue generated from these audits.

Table 4
Individual Income Tax RAR's

	Number of Billings	Amount Billed	Amount Collected
FY 2000	443	$887,968	$299,601
FY 1999	560	$654,938	$185,645
FY 1998	859	$1,174,512	$376,206
FY 1997	634	$1,068,784	$522,204
FY 1996	856	$1,056,587	$719,024

The Special Audits Unit has reduced a backlog and currently has no backlog of Federal RAR's and CP-2000's. They also have plans to develop an automated system for the Federal RAR's as soon as the IRS automates theirs, which should be about two years.

A fair cost-benefit analysis could not be conducted due to the fact that this unit has other functions that do not necessary result in revenue recovery. However, the combined total revenue generated from the CP-2000 and Federal RAR's is more than twice the Unit's salary expenses.

Excise Tax Unit

The scope of the Excise Tax Unit was on the Health Care Provider tax, particularly on the new computer system prototype. The new computer system has made the auditing process more efficient for the auditors. Before the implementation of the computer system in February of 1998, Health Care Provider tax auditors were virtually unable to conduct audits due to limited resources available. Now **all** Health Care Tax returns go through at least one series of checks, to ensure the accuracy of the returns. The new computer system is also able to determine the exact number of health care accounts. Before the system was implemented the only way to determine the total number of accounts was to count the tax returns actually mailed, then only an approximate number could be determined.

The Health Care Prototype system is comprised of four subsystems: Refund, Billing, Auditing, and Pre-Audit. Once a Health Care Provider Tax return is received it is entered into the Prototype System. Each return is automatically audited for internal consistency and prints out an exception report for the auditing staff. The exception report printed is just one tool auditors use when determining which tax returns to audit.

However, this prototype system has some deficiencies. The system currently cannot report the total amount of revenue generated from the audits conducted. Also, the system is unable to report the total amount of refunds that have been issued. The system needs modifications to address these deficiencies. However, the company, *Open Environment Corporation*, that developed the software and designed the prototype applications is out-of-business. Furthermore, the only person able to make any modifications or upgrades is a programmer who works for the Tax Department. The programmer is unable to modify the system due to other priorities within the Department. The Tax Department should consider modifying the prototype system so that the total amount of revenue received from the billing process and total amount of refunds issued by the system can be determined.

The IFTA Unit

According to reviews conducted by the International Fuel Tax Association, **the State's International Fuel Tax Agreement (IFTA) program operates well and is in compliance with most procedural guidelines established by the Association.** This program provides significant administrative benefits to the trucking and busing industry in the state, and it also provides efficiencies for the Tax Department in collecting its state fuel use taxes.

The Internal Auditing Division of the State Tax Department administers the IFTA program. This is an agreement between the 48 contiguous states and the 10 Canadian provinces that facilitates cooperation regarding the reporting and payment of state motor carrier fuel use taxes. Trucking companies that transport through West Virginia must pay taxes on the use of motor fuel that was consumed while they transported through the state. This is to compensate the state for truckers' use of the State's roads. The fundamental principle of IFTA is to allow interstate motor carriers to report and pay such taxes to a **single base jurisdiction**. Prior to IFTA, a motor carrier would have to register with and pay each state it operated in, which caused confusion and an administrative burden for the trucking and busing industry. It also required the state to register and seek payment from thousands of commercial carriers based in many states that transported through West Virginia. The number of carriers that were registered with the State Tax Department in 1996 prior to IFTA implementation was over 42,000. Since joining IFTA, that figure has dropped to 2,526 in FY 2000.

West Virginia implemented the International Fuel Tax Agreement (IFTA) effective January 1, 1996 in accordance with the Intermodel Surface Transportation Efficiency Act (ISTEA) of 1991. According to the State Tax Department, and the United States Department of Transportation, the ISTEA legislation mandated that all states join IFTA by September 30, 1996. The State Tax Department indicates that failure to join IFTA and maintain compliance would affect the State's ability to collect state fuel use taxes which totals over $18 million, and to receive matching federal highway funds. In addition, the *National Conference of State Legislatures* (NCSL) indicated that the ISTEA legislation does not mandate states to join IFTA. The ISTEA legislation requires that if a state is to have a system by which it will report and pay motor carrier taxes to other states for motor carriers as a *base state*, that system must be in conformity with IFTA by September 30, 1996. Nevertheless, the NCSL does agree that a state could lose the ability to collect motor fuel use taxes and any federal matching funds if the state either does not have membership with IFTA or has a system in place similar to IFTA.

Reviews by IFTA's Program Compliance Review Committee indicates that West Virginia's IFTA program does not have serious deficiencies; therefore any possible loss of federal funds is not a concern. West Virginia has had two compliance reviews, the first was in 1997, and the second review was in June, 2000. Both reviews indicated that West Virginia was in compliance with IFTA, with a few exceptions. The Division has addressed many of these deficiencies. Listed below are three recurring deficiencies identified in both reviews:

- Some Tax Report forms for licensees did not contain current tax rates for some States.
- West Virginia did not forward available funds to other States in a timely manner.
- West Virginia did not remit its payments due other States in a timely manner.

The IFTA Unit's budget is approximately $170,000. Annual IFTA membership dues is $8,000. There does not appear to be any negative impact on the collection of Motor Carrier Tax since joining IFTA. Table 5 illustrates that total motor carrier tax revenue collected has grown since the Department joined IFTA.

Table 5: Motor Carrier Tax Revenue

Fiscal Year	Motor Carrier Tax Revenue Before IFTA	Motor Carrier Tax Collected Under IFTA
1993	$10,526,116	
1994	$12,063,359	
1995	$11,528,827	
1996	$8,011,841	$951,927
1997		$17,495,732
1998		$22,817,937
1999		$18,927,212
2000		$18,916,959

Sources: Digest of Revenue Sources for 1993-1996, and the Department of Tax & Revenue for 1996-2000.

Recommendation 1:

The Corporate and Franchise Unit should explore methods to provide greater automation for the corporate net income tax return and other business taxes to assist in auditing a greater percentage of returns. Also, the Division should assess its resources to verify if additional revenue recovery can be obtained cost effectively.

Recommendation 2:

The Tax Department should give greater priority towards having modifications made to the Health Care Provider Tax computer system so that it is able to determine the total amount of audit revenue collected and the total amount of refunds issued through audits conducted.

APPENDIX A

Transmittal Letter to Agency

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

December 22, 2000

Ron Stone, Deputy Tax Commissioner
State Capitol Complex
Building 1, Room W-300
1900 Kanawha Blvd., East
Charleston, WV 25305-0842

Dear Mr. Stone:

Attached is a copy of the report on the Internal Auditing Division. This report will be presented at the January interim which will be held on Sunday, January 7, 2001, between 4 P.M. and 6 P.M. The meeting is scheduled to be held in the Senate Judiciary committee room. We would need to receive your written response to the report no later than Wednesday, January 3, 2001 in order to have it included with the report. Please contact me to schedule an exit conference sometime next week if you feel there is a need to discuss any concerns about the report. Thank you again for all the cooperation we have received during this audit.

Sincerely,

John Sylvia

John Sylvia

Enclosure
cc: Linda Bennett, Director
Internal Auditing Division

Joint Committee on Government and Finance