

STATE OF WEST VIRGINIA
SPECIAL REPORT
OF
WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
FOR THE PERIOD
JULY 1, 2002 - JUNE 30, 2004



OFFICE OF THE LEGISLATIVE AUDITOR
CAPITOL BUILDING
CHARLESTON, WEST VIRGINIA 25305-0610

WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
FOR THE PERIOD
JULY 1, 2002 - JUNE 30, 2004

WEST VIRGINIA LEGISLATURE
Joint Committee on Government and Finance

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CHARLESTON, WEST VIRGINIA 25305-0610

To the Joint Committee on Government and Finance:

The objectives of this internal control study were to understand and evaluate the West Virginia State Tax Department's (Department) internal controls and procedures over the collection and deposit of taxes, tax penalties and interest; and to determine if these internal controls and procedures were consistent with the directives conveyed in the West Virginia Code, legislatively approved rules and regulations, as well as, other rules, regulations, policies, and procedures.


In order to achieve the objectives noted above, we performed the following:

- a. Reviewed applicable sections of the West Virginia Code, the Department's Legislative Rules and Regulations, as well as, other rules, regulations, policies and procedures as they pertain to the assessment, collection and deposit of taxes, tax penalties and interest;
- b. Obtained and reviewed the Department's expenditure schedules, Chart of Accounts and organizational charts;
- c. Conducted interviews with various Department personnel to determine how revenues were processed;
- d. Documented revenue processing procedures and asked the appropriate Department employees to review these written procedures and to make any needed corrections in an effort to ensure their accuracy;

e. Evaluated the adequacy of the Department's revenue processing procedures by determining, among other things, if there was adequate separation of the cash receipts and bookkeeping functions, the ability of employees to override the system of internal controls, and if management reports related to receipts processing are generated and, if so, how are the reports used by management.

Our special report covers the period of July 1, 2002 through June 30, 2004. The results of our work are contained in the General Remarks section of this internal control study.

Respectfully submitted,


Theodora L. Shanklin, CPA, Director
Legislative Post Audit Division

TLS/jda

June 21, 2005

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WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
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WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
EXIT CONFERENCE

We held an exit conference on August 3, 2005 with the State Tax Commissioner and other representatives of the West Virginia State Tax Department and all findings and recommendations were reviewed and discussed. The above officials' responses are included in bold and italics in the Summary of Findings, Recommendations and Responses and after our findings in the General Remarks section of this report.

WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
INTRODUCTION

The Department of Tax and Revenue was created by the 1989 Legislature, which combined the following departments and agencies under the leadership of the Secretary of Tax and Revenue: Alcohol Beverage Control Administration, Retail Liquor Licensing Board, Division of Banking, Board of Banking and Financial Institutions, Lending and Credit Rate Board, Insurance Commission, Lottery Commission, Racing Commission, State Tax Department, and the Property Valuation Training and Procedures Commission. The Department of Tax and Revenue began operations on July 1, 1989. The Department of Tax and Revenue, through the West Virginia State Tax Department, is charged with the responsibility for the enforcement of statutes relating to certain state taxes and collection thereof, including the beer barrel tax, business and occupation tax, business franchise tax, cigarette tax, use tax, consumer sales and services tax, corporate license tax, corporation net income tax, estate tax, gasoline and special fuels excise tax, health care provider tax, motor carrier road tax, nonintoxicating beer tax, personal income tax, severance tax, soft drinks tax, telecommunications tax and wine liter tax. The responsibility for appraising industrial, natural resource and utility properties, overseeing the assessment work of county assessors, preparing the Board of Public Works tentative ad valorem property tax assessments for all public utilities operating within the state, and issuing permits for and regulating bingo occasions and charitable raffles held throughout the State also rests with the West Virginia State Tax Department.

WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
ADMINISTRATIVE OFFICERS AND STAFF
JUNE 30, 2004

Rebecca Melton Craig Tax Commissioner
Christopher G. Morris Assistant Tax Commissioner
Mark S. Morton, Esq. General Counsel
Susan G. Richards Administrative Secretary
Jerry Knight Director, Property Tax Division
Patricia J. Haddy Director, Operations Division
Mark B. Muchow Director of Fiscal Policy
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Linda C. Bennett Director, Internal Auditing Division
William K. James Director, Network and PC Support Division
Dennis F. Ledford Director, Programming Division
Roger D. Cox Director, Research and Development Division
Dana L. Miller Director, Revenue Division
Lee Ann Kennedy Director, Taxpayer Services Division

WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
SUMMARY OF FINDINGS, RECOMMENDATIONS AND RESPONSES

Lack of Effective System of Internal Controls

1. During the course of our examination, it became apparent to us, based on the observed noncompliance with the West Virginia Code, the West Virginia State Tax Department (Department) did not have an effective system of internal controls in place to ensure compliance with applicable State laws, rules and regulations. We believe an effective system of internal controls would have alerted management to these violations at an earlier date and allowed more timely corrective action.

Auditors' Recommendation

We recommend the Department comply with Chapter 5A, Article 8, Section 9 of the West Virginia Code, as amended, and establish a system of internal controls that will serve to alert management to areas of noncompliance with the West Virginia Code and other applicable rules and regulations.

Department's Response

We will comply with the audit recommendation. (See pages 11-13)

Segregation of Duties -
Receipt of Tax Payments and Accounting Entries

2. The Department has a lack of segregation of duties in the areas of access to the accounts receivable system, the billing system and the receiving of payments from taxpayers.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code and strengthen internal controls related to collecting, recording and depositing of tax and fee revenues.

Department's Response

We will comply with the audit recommendation. (See pages 13-17)

Personal Income Tax Return Audit Parameters

3. The Department does not use random sampling techniques to achieve sufficient audit coverage of personal income tax returns.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended. We also recommend the Department establish a random sampling audit plan for use on the general population of personal income tax returns, as well as, review and improve the Department's audit procedures for those returns that are selected for audit.

Department's Response

We will comply with the audit recommendation. (See pages 17-21)

- 4.

RELATED TO CRIME PREVENTION

RELATED TO CRIME PREVENTION

Inactivation of Accounts in the Business Master File

5. Some employees of the Department were following an unauthorized process in making determinations of accounts which should be moved to “inactive status” in the Business Master File thereby making those business accounts no longer subject to the Department’s compliance monitoring and auditing procedures.

Auditors’ Recommendation

We recommend the Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended. We further recommend the Department strengthen procedures to ensure that businesses are no longer engaged in business activities prior to rendering them inactive.

Department’s Response

We will comply with the audit recommendation. (See pages 25-30)

Oversight of the Health Care Provider Tax

6. The Department does not have sufficient procedures in place to ensure all taxpayers who are subject to the Broad Based Healthcare Provider Tax and the Healthcare Severance Tax are filing returns on a timely basis and paying taxes due the State of West Virginia.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 10, Section 3, as amended; Chapter 11, Article 10, Section 5, as amended; and, Chapter 11, Article 10, Section 11, as amended, of the West Virginia Code. We further recommend the Department establish internal controls that ensure Health Care Providers are filing Broad Based and Healthcare Severance tax returns on a timely basis and paying the required taxes due.

Department's Response

We will comply with the audit recommendation. (See pages 30-37)

Discount for Other Tobacco Products

7. The Department is allowing taxpayers who are subject to the Tobacco Products Excise Tax to apply a discount of four percent of the gross tax due with respect to "other tobacco products".

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended. We further recommend the State Tax Department review the language of Title 110, Series 17, Section 4.6.5 of their Legislative Rules

and determine whether the language contained there is in conflict with the provisions of Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended.

Department's Response

We believe the 4% discount has been administered in accordance with statutory mandates. (See pages 37-41)

Inventory Controls Over Cigarette Stamps and Soft Drink Stamps

8. The Department did not have an adequate segregation of duties related to inventory controls over Cigarette Stamps and Soft Drink Stamps.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 17, Section 7 and Chapter 11, Article 19, Section 5, as amended, of the West Virginia Code. We also recommend the Department establish inventory procedures for cigarette and soft drink stamps that incorporate segregated duties for the custody of the stamps, record keeping and inventory verification counts.

Department's Response

We will comply with the audit recommendation. (See pages 41-45)

Accounts Receivable Records for Beer Barrel and Wine Liter Taxes

9. The Department does not maintain accounts receivable ledgers for Beer Barrel and Wine Liter taxes.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 10, Section 5 of the West Virginia Code, as amended. We further recommend the Department establish an effective accounts receivable system for Beer Barrel and Wine Liter Taxes.

Department's Response

We will comply with the audit recommendation. (See pages 45-47)

Estimated Payments of Health Care Provider Taxes

10. The Department does not monitor Healthcare Provider estimated tax returns for underpayment of estimated taxes and, therefore, does not impose interest on provider underpayments or late payments of estimated taxes.

Auditors' Recommendation

We recommend the Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended. We further recommend the Department establish and enforce a procedure whereby health care provider estimated tax returns are monitored for underpayments of estimated taxes and assessed penalties for late payments and underpayments in accordance with State law.

Department's Response

We will comply with the audit recommendation. (See pages 47-51)

Late Deposits

11. Certain tax receipts referred to as "miscellaneous split" receipts are not deposited within 24 hours of receipt as required by State law.

Auditors' Recommendation

We recommend the Department comply with Chapter 12, Article 2, Section 2 of the West Virginia Code, as amended, and deposit tax payments within 24 hours of receipt.

Department's Response

We will comply with the audit recommendation. (See pages 51-54)

WEST VIRGINIA STATE TAX DEPARTMENT
INTERNAL CONTROL STUDY OF
REVENUE OPERATIONS AND TAX COLLECTIONS
GENERAL REMARKS

INTRODUCTION

We have completed an internal control study focusing on the internal controls and procedures over the revenue operations and tax collections procedures of the West Virginia State Tax Department. The study covered the period July 1, 2002, through June 30, 2004.

Lack of Effective System of Internal Controls

During the course of our review, it became apparent to us, based on the observed noncompliance with the West Virginia Code and other rules and regulations, the State Tax Department did not have an effective system of internal controls in place to ensure compliance with applicable State laws, rules and regulations.

Chapter 5A, Article 8, Section 9(b) of the West Virginia Code, as amended, states in part:

“The head of each agency shall: . . .

(b) Make and maintain records containing adequate and proper documentation of the organization, functions, policies, decisions, procedures and essential transactions of the agency designed to furnish information to protect the legal and financial rights of the state and of persons directly affected by the agency’s activities. . . .”

This law requires the agency head to have in place an effective system of internal controls in the form of policies and procedures set up to ensure the agency operates in compliance with the laws, rules and regulations which govern it.

During our review we noted the following violations of State laws or other rules and regulations: (1) The Department has a lack of sufficient segregation of duties in the area of access to the accounts receivable system, the billing system and the receiving of payments from taxpayers. (2) The Department does not use random sampling techniques to achieve sufficient audit coverage of personal income tax returns. (3)

RELATED TO CRIME PREVENTION

(4) Some employees of the Department were following an unauthorized process in making determinations of accounts which should be moved to "inactive status" in the Business Master File thereby making those business accounts no longer subject to the Department's compliance monitoring and auditing procedures. (5) The Department does not have sufficient procedures in place to ensure all taxpayers who are subject to the Broad Based Healthcare Provider Tax and the Healthcare Severance Tax are filing returns on a timely basis and paying taxes due the State of West Virginia. (6) The Department is allowing taxpayers who are subject to the Tobacco Products Excise Tax to apply a discount of four percent of the gross tax due with respect to "other tobacco products." (7) The Department did not have an adequate segregation of duties related to inventory controls over Cigarette Stamps and Soft Drink Stamps. (8) The Department does not maintain accounts receivable ledgers for Beer Barrel and Wine Liter taxes. (9) The Department does not monitor Healthcare Provider estimated tax returns for underpayment of estimated taxes and, therefore, does not impose interest on provider underpayments or late payments of estimated taxes. (10) Certain tax receipts referred to as "miscellaneous split" receipts are not deposited within 24 hours of receipt as required by State law.

We recommend the Department comply with Chapter 5A, Article 8, Section 9(b) of the West Virginia Code, as amended, and establish an effective system of internal controls that will serve to alert management to areas of noncompliance with the West Virginia Code and other applicable rules and regulations.

Department's Response

According to the preliminary draft of the General Remarks section of the completed report of the West Virginia State Tax Department – Internal Control Study of Revenue Operations and Tax Collections for the period July 1, 2002 through June 30, 2004, the audit conducted by the Legislative Post Audit Division revealed a lack of an effective system of internal controls.

The current Acting Tax Commissioner cannot comment with certainty regarding past Commissioners' attitude toward internal controls. The Legislative Auditor can be assured, beyond any doubt, that this Commissioner, who was appointed by Governor Manchin on January 17, 2005, and who has been licensed to practice as a Certified Public Accountant for over thirty years, brings a very serious and professional attitude toward the implementation, maintenance, and monitoring of the Agency's internal controls.

Segregation of Duties -

Receipt of Tax Payments and Accounting Entries

During our review of the internal controls over the collection and deposit of tax revenues, we were told two former employees of the Department's Compliance Division were found to have embezzled tax payments prior to our audit period. The former employees were able to exploit system weaknesses because they had the simultaneous ability to receive a payment from a taxpayer, convert the tax payment to their own personal use, and conceal the theft by deleting all or

part of the corresponding receivable in the accounts receivable system and/or suspend the billing process with respect to the receivable.

According to information provided by the Department, the accounts receivable balances totaled \$91,363,722.12 as of June 30, 2004, and consisted of \$59,637,765.46 in the Business Tax Accounts Receivable (AREC) System and \$31,725,956.66 in the Personal Income Tax System (PITS). We also noted the Compliance Division received payments totaling \$85,424,830.27 and the Accounts Monitoring Unit received payments totaling \$2,259,373.17 during Fiscal Year 2004. Considering the large dollar amount of the receivables and collections, and based on the apparent lack of internal controls that previously enabled employees to exploit weaknesses over the collection and deposit of certain payments, we determined if other Department employees still have the same system abilities granted to them as those system abilities granted to the former employees who committed the documented acts of embezzlement. We also attempted to determine what specific supervision, if any, is conducted with respect to the activities of these employees. Further, we are concerned there may be additional embezzled tax payments that have not yet been discovered by management.

Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended, states in part:

“It shall be the duty of the tax commissioner to see that the laws concerning the assessment and collection of all taxes and levies, whether of the State or of any county, district or municipal corporation thereof, are faithfully enforced....” (Emphasis Added)

We requested Data User Access Reports for AREC and PITS from the Tax Department’s Programming Division in order to determine the “permissions” granted to those employees that have access to these accounting systems. We also attempted to determine what

specific supervision, if any, is conducted with respect to the activities of these employees. Based on our work, we found 114 employees had the ability to access the payment system, the Department's accounts receivables system, as well as, access to the billing system module in the AREC system and 93 employees had the same abilities in the PITS system. Most of these same employees were also in a position to receive taxpayer payments in the normal course of their duties. It is important to note that these employees received payments and performed accounting entries with a general lack of sufficient management oversight.

Of the employees listed above that had account update access in AREC and PITS, 46 individuals were Compliance Division employees and seven individuals were Internal Auditing Division - Accounts Monitoring Unit employees. The Compliance Division and the Accounts Monitoring Unit employees are of particular concern since they routinely access the accounts receivables database or perform functions related to taxpayer billings and they routinely receive accounts receivable payments from taxpayers. We learned, in some cases, management was unaware of the full ramifications of the particular accounts receivable system capabilities of their staff, until we discussed the internal control environment with management and the nature of the weaknesses and the need to strengthen the system of internal controls was realized.

Our inquiries have indicated there is no established automated approval process utilized within the accounting systems which requires supervisory approval for employee system entries, no reconciliations are performed between the receipts posted in AREC and PITS and the amounts deposited in State accounts, and no supervision has been historically exercised over deleted accounts receivable or suspended billings.

We recommend the Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code and strengthen internal controls related to collecting, recording and depositing of tax and fee revenues.

Department's Response

The Department has taken steps to monitor and limit employee access to the Personal Income Tax billing system and the Accounts Receivable system.

The Internal Auditing Division has removed update capabilities in the Personal Income Tax and Accounts Receivable systems from 19 employees and has limited the access for an additional 14 employees. The Programming Division will separate update and inquiry/comment only functions in both the PIT & AREC Systems. This modification will allow the Department to further segregate the update functions in both systems. Each employee will be granted specific update access based on their job requirements. This change, scheduled for completion by September 1, 2005, will further reduce the number of employees having full update capabilities. However, because of the requirements of their job, some Internal Auditing employees will continue to have update capabilities in PITS & AREC and also receive payments from taxpayers. To monitor those employees, as well as all other employees, the Programming Division has developed two separate security reports for each system. Each Tax Unit Supervisor & Assistant Director will receive a daily Billing Update Report and Payment Report showing the previous day's activity for their review. Procedures for reviewing these reports and verification of transactions will be established.

The Compliance Division will remove the capability to delete or suspend a billing in the AREC system from all 34 revenue agents on September 1, 2005. Any request for manual

updates to AREC will be submitted in writing to the appropriate manager. The manager will review the request and make the appropriate update to the billing systems. The written documentation will be forwarded to Compliance Headquarters to be reviewed by the Assistant Director against the daily Delete/Suspend reports to be provided by the Programming Division.

Further, we will remove the capability to delete a billing in the PITS system from 34 revenue agents and remove the capability to suspend or update from 24 of those agents on September 1, 2005. Due to the volume of personal income tax cases, 10 in-house revenue agents will retain the capability to suspend or update a PITS billing. However, the Unit Manager or Assistant Director will review daily Delete/Suspend reports. Deletions, as in AREC, will need prior written approval from and be performed by the appropriate manager. The written documentation will be retained in Compliance Headquarters and reviewed by the Assistant Director against the daily Delete/Suspend reports to be provided by the Programming Division.

Personal Income Tax Return Audit Parameters

During our review of the Department's audit procedures of West Virginia personal income tax returns, we learned the Department does not use random sampling techniques to achieve sufficient audit coverage of personal income tax returns. Even with the Department's established audit parameters, generally described below, the Department's audit procedure has failed to prevent substantial erroneous overpayments of personal income tax refunds.

Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended, states in part:

“(a) General – The tax commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable....” (Emphasis Added)

Also, Chapter 11, Article 10, Section 3, of the West Virginia Code, as amended, states in part:

“(a) The provisions of this article shall apply to... the personal income tax...” (Emphasis Added)

According to information provided by the Department, the Department processed \$103,870,867.00 and \$99,914,249.00 in personal income tax refunds for Tax Years 2003 and 2002, respectively. Based on conversations with Internal Auditing Division personnel, we found that returns related to those refunds were generally not “audited” by Department staff unless one of the following special conditions applied:

- The refund claimed by the taxpayer exceeded a specified dollar amount;
- The total estimated tax payments received by the Department failed to match the total estimated payments claimed by the taxpayer on their annual tax return;
- The “Schedule M” modifications exceeded a specified dollar amount for a “single” return or a “joint” return, depending on the type of return filed;
- The taxpayer claimed certain tax credits;
- The return was not mathematically correct; or,
- The return was flagged as a return suspected to contain fraudulent data.

If a taxpayer files a return that is not flagged by the Department as having one or more of the aforementioned special conditions apply to it, the return will not generally be audited. We also confirmed there is no random sampling audit plan used on the general population of personal income tax returns. Instead, exception reports are generated by the Personal Income Tax Data Jobs Coordinator (DJC) of personal income tax returns that meet the criteria listed above. One of the DJC reports lists each tax return with a calculated refund exceeding a specified dollar amount; however, as stated earlier, the average refunds for 2003 and 2002 were less than the established threshold. Even with the established threshold, we were told by a Department employee of an instance where a taxpayer who filed an electronic return was incorrectly sent a refund totaling \$64,000.00 when the

amount refunded should in fact have been \$64.00. The taxpayer notified the Tax Department of the error and the check was returned.

The Internal Auditing Division Assistant Director for the Income Tax Section told us the established refund minimum amount selected by management for inclusion on the exception report is used in order to limit the number of returns selected for audit to a manageable number. Based on our discussions with Internal Auditing Division personnel who have auditing responsibilities with respect to personal income tax returns, we do not believe consideration has been given to setting the refund threshold at an amount less than the current figure and, concurrently, making use of random sampling techniques to achieve sufficient audit coverage of personal income tax returns.

Also, we learned of two instances where taxpayer's accounts were incorrectly credited with employee withholdings resulting in overpayments of personal income tax refunds to these two taxpayers totaling \$1,824.00. These overpayments were mailed even though the electronic tax returns remitted by the taxpayers contained account errors which should have prompted a "manual desk-audit" of the tax returns by the Department. Specifically, the total tax payments credited to the taxpayer accounts in the Personal Income Tax System failed to match the total payments claimed by the taxpayers on their returns.

A refund check for \$1,237.00 was processed for one of these taxpayers on March 7, 2005, while the amount refunded should have been \$912.00. The taxpayer was subsequently billed by the Department for the refund overpayment of \$325.00; however, as of June 16, 2005, the taxpayer had not remitted payment. The Tax Department processed the other taxpayer's refund on March 3, 2005, for \$1,489.00 when the amount refunded should have been \$287.00. On April 18,

2005, another check was issued to the taxpayer for what was the correct refund amount of \$287.00. According to the Assistant Director of Internal Auditing Division, this check should not have been issued; rather, the taxpayer should have been billed for the initial overpayment of \$1,202.00 at the time the overpayment was first noticed. As of the time of our inquiry on this matter on June 16, 2005, the overpayment remained outstanding and the taxpayer had yet to be billed for the net overpayment of \$1,489.00.

We recommend the Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended. We also recommend the Department establish a random sampling audit plan for use on the general population of personal income tax returns, as well as, review and improve the Department's audit procedures for those returns that are selected for audit.

Department's Response

Based on statistics from tax year 2004, approximately 14% of Personal Income Tax returns processed meet one of the exception criteria programmed into the Personal Income Tax Audit System that would flag the account for further review.

In addition to auditing these accounts, the Department has implemented security measures to stop potential refunds generated by the filing of fraudulent returns. West Virginia exchanges information with other states through a "clearinghouse" operated by the Montana Department of Revenue. States report the names and social security numbers of suspected fraudulent filers. This information is entered into our Personal Income Tax System and any pending refund to these individuals is captured regardless of the amount.

Fraudulent filers will usually file multiple returns under different names and social security numbers to be mailed to the same address or to be electronically deposited into the same

account. Zip code, routing numbers and account numbers are entered into the Personal Income Tax System enabling the Department to capture potential refunds generated from a fraudulent return filed by individuals whose social security number and name have not been disclosed to us by other states. Any refund to be mailed to an address or deposited into an account previously identified on other fraudulent returns would be audited regardless of the amount of the refund.

Thus far, for the 2004 income tax filing season, these security measures have prevented approximately \$429,464 in erroneous refunds from being issued.

Returns not meeting any of the exception criteria have not been subject to audit review unless we receive that account on a federal audit tape. In response to the Legislative Audit Report, the Department will begin implementing a random audit selection program of Personal Income Tax returns that do not meet the exception criteria.

The random audit selection program was implemented on August 1, 2005, after the Department completed refund processing. Additional random sampling audits will be conducted throughout the year and will include remittance returns, returns filed with August 15th and October 15th extensions, and returns reflecting withholding amounts in excess of 10% of the reported Federal Adjusted Gross Income. This program will be fully implemented by December 31, 2005.

With implementation of the random audit selection program, the Department is of the opinion that the current refund threshold is an effective and manageable number without adding additional staffing resources. Most of the errors cited were listed on exception reports, but occurred due to human error.

RELATED TO CRIME PREVENTION

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Inactivation of Accounts in the Business Master File

The Tax Department maintains a database file (Business Master File) where the names and profiles are maintained for businesses subject to any of the various business taxes established by the State of West Virginia. According to data provided by the Department's Programming Division, 26,433 and 27,729 businesses were inactivated in the Tax Department's Business Master File during fiscal years 2004 and 2003, respectively. At least one such inactivated company, a "broad based health care" provider, was later found to have still been conducting business in West Virginia after its date of inactivation. Documents we reviewed indicated approximately 4,000 companies remitted \$156,073,385.49 in Severance and Broad Based Healthcare Provider Taxes during Fiscal Year 2004.

Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended, states in part:

"It shall be the duty of the tax commissioner to see that the laws concerning the assessment and collection of all taxes and levies, whether of the State or of any county, district or municipal corporation thereof, are faithfully enforced...." (Emphasis Added)

Companies conducting business in West Virginia are required by the Department to complete a Business Registration Application. The answers provided to questions on the application indicate the types of tax returns the company will be expected to file with the State Tax Department. Information contained on the business application is entered into the Business Master File/Detail Payments database in the form of an "active" business account. The information in these active accounts is later processed by the Department's Data Job Coordinators to determine the tax returns and related forms that are to be filed by the business. If an account is "inactivated" in the Business Master File when the business is still actively engaged in business, the Department would not know if the company filed the applicable returns when required.

We were told by the Supervisor of the Department's Office of Business Registration, businesses must state in writing or indicate on a remitted tax return that they are no longer conducting business in West Virginia before the business will be inactivated in the Business Master File by his Unit. On the other hand, the Supervisor of the Department's Business Systems Entry Unit told us employees in her unit will automatically place a company in "inactive status" in the Business Master File if an employee notices the company has not renewed its business registration certificate. The Business Systems Entry Unit Supervisor said it cannot be determined from data contained in the Business Master File whether a business was inactivated because of its own request to be inactivated or inactivated by an employee of her unit following their procedure.

More importantly, inactivated businesses are not subject to Compliance Division delinquency runs and corresponding audits for delinquent tax filings if the inactivation date is prior to the beginning date for the delinquency run period. Plus, the random sampling techniques developed by the Auditing Division of the State Tax Department are used only for active businesses

included in the Business Master File. Since only active businesses are included in this audit population, there is no possibility of a business placed in “inactive status” being selected for audit by this method.

Our concern is an indeterminable number of businesses may still be conducting business in West Virginia after being placed in “inactive status” in the Business Master File. The possibility exists that a business who fails to renew their business license and chooses to ignore the Department’s follow-up inquiries can simply disappear from the Department’s oversight functions and the Department may not have sufficient, specific procedures in place to determine whether such business entities are still conducting business in West Virginia.

We recommend the Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended. We further recommend the Department strengthen procedures to ensure that businesses are no longer engaged in business activities prior to rendering them inactive.

Department’s Response

The Legislative Auditor’s report recommends that the Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended in relation to placing accounts on an “inactive status.” Further, the report recommends that the Department strengthen procedures to ensure that businesses are no longer engaged in business activities prior to rendering them inactive.

The Department accepts the recommendations of the Legislative Auditor and provides the following information relating to the alleged violations and recommendations and the actions taken by the Department to address these findings.

Each year, many accounts are legitimately placed on inactive status. Reasons for placing a taxpayer's account on inactive status include:

- Taxpayer ceased conducting business/closed a specific business location.*
- The taxpayer's address is no longer a valid address according to the U. S. Post Office and no subsequent address can be identified.*
- Taxpayer's account was originally established under a temporary identification number and is being changed to a permanent identification number.*
- Taxpayer has duplicate accounts.*
- Corporate mergers, dissolutions and withdrawals.*
- Business ownership changes.*

A Business System Entry Unit operator placing an account in the "inactive" status due to the operator's own determination is a very rare occurrence, which happens perhaps 100 times a year. Operators in the unit are not instructed to determine account status information for each account processed. The following is an example of an instance where an operator would make a determination to place an account in the "inactive" status.

The Tax Department receives a tax return that contains a nine-digit account number or an individuals' name. Upon review of our data system, the operator determines that there are duplicate or multiple tax accounts for this business or individual and all of the accounts are actively slotted for the tax in question. Normally, a taxpayer is only entered into the system with one account for specific tax filing responsibilities. During their review of this taxpayer's account, the Business System Entry Unit operators would access the detail payments files to determine the account to which the tax return should be applied. If the operator discovers that at least one of the accounts established for that taxpayer has no record of tax return filings for the last several periods where there should have been filings, and where the records show the taxpayer has been filing those returns under another account, the operator would then review the account's business registration certificate renewal filings. The operator would combine the renewal information with the fact that returns for the only tax in the account have been filed under another account number, and the operator would then place the account in the "inactive" status.

compliance.

erroneously inactivated accounts, and initiate contact to bring the taxpayer back into Department will identify any discernable error pattern and produce a report identifying month's inactivate accounts. If wrong decisions are also found in the second sample, the is found to be wrong out of the sample, the Department will sample 10% of the previous program to verify that the decision to inactivate was accurate. If an inactivate decision sample of the accounts inactivated will be produced. The Department will initiate a each month, beginning the first week of September 2005, a report containing a random sampling process for all accounts inactivated during the previous month. Once

- To guarantee that the decision to inactivate an account is accurate, we are to establish a

following procedures:

To provide additional assurance in the future, the Department is implementing the

Income Tax and Business Franchise Tax.

included with our coupon packets for Consumer Sales Tax, Withholding Tax, Corporation Net statement from the taxpayer by letter, note on a filed tax return, or the change order request requiring that a business tax account will only be inactivated based upon a written, signed provide some assurance in these situations, a Department wide policy has been implemented every single instance when a taxpayer indicates that they have ceased conducting business. To Since the Department manages over 1 million tax accounts, it is impossible to verify when situations as described above occur.

Revenue Division were instructed to discontinue the process of inactivating business tax accounts Effective June 10, 2005, the operators in the Business Systems Entry Unit of the

- *One August 5, 2005, The Department began producing a report that indicates when a return/payment is loaded to an inactive account on August 5, 2005. This report will be used to identify what the taxpayer is doing. Based upon this report and the investigation into the taxpayer's activity, the taxpayer's business tax master file will be restored to active status.*
- *To address the issue of tax accounts being inactivated as a result of return mail from the U. S. Post Office indicating that the address on file is no longer a valid address, the Department is pursuing participation in the National Change of Address Program available through the U.S. Post Office for all business tax addresses.*
- *Finally, part of our project to replace our existing systems with a new integrated tax system includes establishing a data warehouse which will be used to match data from other state agencies and outside sources to identify taxpayers not properly filing and paying their state taxes. We anticipate that this data warehouse will provide us with additional options for verifying the accuracy of decisions to "inactivate" a tax account.*

Oversight of the Health Care Provider Tax

According to a spreadsheet dated March 22, 2005, provided to us by the Department's Compliance Division, a health care provider owed \$1,012,120.97 in Health Care Broad Based and Health Care Severance taxes, additions to tax (penalties) and interest for the period of March 1, 2002, through January 31, 2005. We learned the provider contacted the Tax Department during October or November 2004, and requested amnesty for unpaid taxes. Prior to this contact, Tax Department personnel were unaware that the company had failed to file numerous estimated tax returns and only filed one of six required annual returns since July 1, 2001.

Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended, states in

part:

“The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any other articles of this chapter to which this article is applicable...” (Emphasis Added)

In addition, Chapter 11, Article 10, Section 5, of the West Virginia Code, as amended,

states in part:

“...The tax commissioner shall administer and enforce each tax to which this article applies and, in connection therewith, shall prescribe all necessary forms...” (Emphasis Added)

Lastly, Chapter 11, Article 10, Section 3, of the West Virginia Code, as amended,

states in part in part:

“...The provisions of this article apply to the...health care provider tax...administered by the tax commissioner...” (Emphasis Added)

The Broad Based Healthcare Provider Tax is imposed on the gross receipts for 16 services or categories of healthcare providers. In addition, a Medicaid severance tax is applied to Behavioral Health Service (BHS) providers. Healthcare providers are required to file 11 monthly estimated tax returns, and if applicable, remit estimated payments. An annual return is due within one month of the taxpayers' fiscal year-end date. Estimated payments for the tax year are reported on the annual return and are applied to the total tax due for the year. If the estimated tax payments are less than the amount of tax due for the year, payment of the difference is due at the time the annual return is filed. If estimated tax payments exceed the total tax due for the tax year, a credit may be taken for the overpayment in the following year or the taxpayer may elect to have the overpayment refunded.

According to the Supervisor of the Department's Excise Tax Unit, no record is currently being kept, nor has any record historically been kept, by the Unit of the filing status or payment status of the taxpayers falling under the Broad Based Healthcare Provider Tax due to the large number of taxpayers (4,187 as of June 22, 2005) subject to that tax. The Unit is currently attempting to keep such a record for taxpayers subject to the Healthcare Severance Tax (137 as of June 22, 2005) since the Unit became aware of the above provider's delinquency.

We were told that the Tax Department's Compliance Division is responsible for the production of Healthcare "Delinquency Runs," which will alert the Department that a taxpayer has not filed tax returns. According to a memorandum provided by the current Director of the Compliance Division, the last Healthcare Delinquency Run was performed on January 6, 2003, for calendar years 2000 and 2001. Although Department staff members were unable to tell us the exact date the company was inactivated, the company was officially listed as an "Inactive" account in both the Business Master File, as well as, the Health Care System as of December 31, 2003.

It should be noted the company was not delinquent during years 2000 or 2001. Nevertheless, if a Health Care Delinquency Run had been completed for any period beginning after the inactivation date, the taxpayer would not have been included in the report and, consequently, would not have been identified as a delinquent tax filer. Although they were inactive in the Business Master File and the Health Care System, the company continued to remit withholding and Corporate Charter taxes with the Department.

As described above, the Department does not have internal controls in place to ensure that Health Care Providers are filing Broad Based and Healthcare Severance tax returns on a timely basis and paying taxes due the State of West Virginia. Therefore, we believe there is a strong

possibility other providers, of which the Department is not aware, have not properly filed Broad Based and Healthcare Severance tax returns and paid all of the Healthcare taxes due the State.

We recommend the Department comply with Chapter 11, Article 10, Section 3, as amended; Chapter 11, Article 10, Section 5, as amended; and, Chapter 11, Article 10, Section 11, as amended, of the West Virginia Code. We further recommend the Department establish internal controls that ensure Health Care Providers are filing Broad Based and Healthcare Severance tax returns on a timely basis and paying the required taxes due.

Department's Response

The Healthcare Provider tax system database identifies taxpayers who are subject to the tax. The system records the filings and payments received, and identifies those taxpayers who have not filed the required returns. At issue is whether or not the Department has exercised due diligence in utilizing the information contained in the Healthcare Provider tax system to ensure that taxpayers are meeting their responsibilities. Clearly, past weaknesses have been identified in the administration of Healthcare Provider Broad Based and Severance taxes.

The following measures will be taken to ensure that the Department is in compliance with Chapter 11, Article 10, Section 3, as amended; Chapter 11, Article 10, Section 5, as amended; and, Chapter 11, Article 10, Section 11, as amended, of the West Virginia Code:

Annual Delinquency Runs

The Compliance Division, with the assistance of the Networking and Programming Divisions, identifies and mails to non-filers a Delinquency Notice, which requires the taxpayer to respond by a date certain and either file missing returns, or provide an explanation as to why no filing is required. These "Delinquency Runs" are conducted for business taxes administered

through the AREC system twice a year. Delinquency run cases are assigned to the regional offices to be worked by Tax Department field personnel. A user request must be submitted to the Programming Division to produce the report and generate the delinquency notice. The Assistant Director of the Compliance Division makes the decision as to when the notices are produced and mailed to taxpayers for taxes administered by the AREC system. This individual oversees field operations and insures that the "Delinquency Runs" are conducted timely in accordance with the twice a year guidelines established by the Division.

Since the Healthcare Provider tax utilizes a separate accounts receivable system, the "Delinquency Run" for the Healthcare Provider tax must be conducted separately from other business taxes. The Internal Collections Unit located in the Compliance Division Headquarters administers the run. As with the "Delinquency Run" conducted for other business taxes, a user request must be submitted by the Compliance Division to produce and mail the notices. The Healthcare tax return is filed with an annual return, so the Healthcare Delinquency Notices are produced once a year, and address the non-filings for the previous year. These delinquencies are monitored in-house by the Internal Collections Unit, and the decision to produce and mail the notices is made by the Director, who oversees the in-house operations of the Division, and Unit Manager of the Internal Collections Unit.

The most recent Healthcare "Delinquency Run" conducted by the Division covered tax years 2000 and 2001. This run was produced and mailed to the taxpayers on January 6, 2003. The Division failed to conduct subsequent runs. This failure will be corrected.

In March of 2005, the Compliance Division acquired a new Acting Director. He discovered the failure to perform the Healthcare Delinquency Run, and promptly submitted a user

request to the Networking Division. Delinquency Notices for tax years 2002 and 2003 were produced and mailed to taxpayers in May, 2005. The importance of completing the Healthcare Delinquency Runs at regular intervals has been discussed with the Unit Manager of the Internal Collections Unit. In the future, Delinquency Notices will be produced and mailed once a year and will coincide with the May Delinquency Run for all other business taxes.

Further, the Networking Division has added, effective August 4, 2005, the production and mailing of the Delinquency Notices to their regularly scheduled production routine. The notices will be produced and mailed on May 1, or the first working day in May of each year. Once this procedure is in place, the scheduling and production of the Healthcare Provider Delinquency Notices will be an automated function, and will not require a user request for each run. This will guarantee that Healthcare Provider delinquencies are reviewed on an annual basis.

Increase Control over the Inactivation of Tax Accounts

The Department conducted a review of all returns and correspondence received from the taxpayer described in this report and could not determine why the taxpayer's filing status was rendered inactive. To prevent future incidents of this nature from occurring, each employee has been reminded that procedure requires written notification from the taxpayer before an account status can be inactivated. The Business System Entry Unit of the Revenue Division has been instructed that each request received to inactivate a taxpayer's account must be accompanied by the appropriate written documentation from the taxpayer authorizing the status change. Additionally, the taxpayer correspondence will be added to image archives to ensure that the documentation is retained for future reference.

Review of Inactivated Accounts

The report describes a taxpayer which continued to file withholding tax returns for taxable periods after the inactive date referenced in the Department's Healthcare system and Business Master File. Effective September 1, 2005, the Networking and Programming Divisions will produce a monthly report that will identify any taxpayer account where transactions have been posted to the accounts receivable systems after their inactive date. Once identified, the Department will review these tax accounts. If it is determined that the taxpayer has not filed all required returns, the Compliance Division will contact the taxpayer regarding the missing returns to ensure that they are filed. Additionally, by September 1, 2005, the Networking Division will provide the means to allow the Compliance Division to produce a report by date, of accounts that have been inactivated in the Healthcare System. These accounts will be reviewed daily to determine if the taxpayer has truly discontinued business and if the appropriate procedure for inactivating the accounts has been applied.

Also, the Department has contacted the Department of Health and Human Resources and will attempt to arrange the receipt of an annual report documenting the Medicaid reimbursements made to healthcare providers during each calendar year. This report will be compared to our Healthcare Provider tax system to ensure that each provider receiving reimbursements is properly registered with the Tax Department and is filing tax returns and remitting as required.

These measures will assist the Tax Department in ensuring that taxpayer accounts are not improperly inactivated and that all required returns are filed.

Implementation of controls described above will allow the Department to better assist taxpayers in achieving compliance with State tax laws and will provide assurance that those taxpayers who should file returns and remit taxes are meeting their obligations.

Discount for Other Tobacco Products

“Other Tobacco Products” (OTP) is the classification given by the State Tax Department for all tobacco products other than cigarettes that are subject to the Tobacco Products Excise Tax. The OTP gross tax due is calculated by applying the seven percent tax rate to the wholesale purchase price and subtracting 95% of the tax previously paid on returned merchandise. According to the Department’s Excise Tax Unit Supervisor, the Department permits taxpayers to apply a discount of four percent to the gross tax due. This discount is incorporated into the monthly OTP tax form used by taxpayers to calculate the net tax due to the State Tax Department.

Chapter 11, Article 17, Section 9, of the West Virginia Code, as amended, states in part:

“A discount of four percent will be allowed on all tax due for persons affixing stamps, collecting and paying of tax as required and prescribed by this article.” (Emphasis Added)

Further, Title 110, Series 17 of the State Tax Department’s Legislative Rules states in part,

“4.6.5 Every taxpayer that pays the excise tax on tobacco products shall be allowed a discount of 4 percent on all tax due.”

We believe the language of Section 4.6.5 of the State Tax Department’s Legislative Rules is in conflict with the provisions of Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended. The conflict occurs because the Department’s rules allow taxpayers handling

“other tobacco products” to get the same discount as taxpayers who are affixing stamps as required by West Virginia law. The apparent purpose of the provisions of Chapter 11, Article 17, Section 9, as amended, was to compensate taxpayers for the practice of affixing stamps by allowing them to take a four percent discount on all tax due from them. The practical application of the Department’s Legislative Rules is to allow taxpayers who are not providing any services in helping to administer the tax laws of West Virginia to take the same four percent discount as those who are providing such services.

Unlike the tobacco taxes on cigarettes, OTP taxes are not paid through stamp purchases and, therefore, the taxes are required to be remitted to the Department in conjunction with the OTP tax return. Tax receipts for OTP are deposited into the State General Revenue Fund - Account 0490-596. According to the aforementioned section of State law, the four percent discount is granted “for persons affixing stamps, collecting and paying of tax.” Since OTP taxpayers do not affix stamps to OTP, we believe OTP taxpayers are not entitled to the four percent discount authorized by Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended. Due to the application of this unauthorized discount, we estimate the State Tax Department has failed to collect tobacco products excise taxes of approximately \$197,000.00 and \$193,000.00 for fiscal years 2004 and 2003, respectively .

The Department’s Assistant Director for the Internal Auditing Division told us the Tax Department’s Legal Division ruled the four percent discount must be allowed for OTP taxpayers, as well as cigarette taxpayers, even though OTP taxpayers do not affix stamps to OTP.

We recommend the Department comply with Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended. We further recommend the State Tax Department review the

language of Title 110, Series 17, Section 4.6.5 of their Legislative Rules and determine whether the language contained there is in conflict with the provisions of Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended.

Department's Response

In 2001, the Cigarette Excise Tax Act was amended and the title changed to Tobacco Products Excise Tax, imposing the excise tax on "other tobacco products." The tax is imposed on the wholesale price of products sold in the State. The Department designed the tax return for the reporting and paying of the tax on such sales without any discount. The return was distributed to the West Virginia Wholesalers Association for their membership to review. Once it was reviewed, the Association representatives questioned the fact that there was no 4% discount allowed for tobacco products other than cigarettes. They asserted that the legislative intent was to allow the 4% discount on the tax amount due on the sale of other tobacco products, and that the discount for other tobacco products should be consistent with the tax on cigarettes.

Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended, states in part:

A discount of four percent will be allowed on all tax due for persons affixing stamps, collecting and paying of tax as required and prescribed by this article. (Emphasis Added)

Pursuant to the specific request of the Legislative Rulemaking Review Committee, the Tax Department changed its originally proposed regulation to allow the 4% discount to be applied to all tobacco products taxed under Chapter 11, Article 17.

An emergency legislative rule, Title 110, Series 17, Tobacco Products Excise Tax, was filed on January 22, 2002 in which the 4% discount was applied to collecting and paying tax

on other tobacco products. Additionally, a legislative rule Title 110, Series 17, Tobacco Products Excise Tax, had been filed with the Legislative Rule-Making Review Committee on July 23, 2001. That legislative rule was amended and authorized by the Legislature in the 2002 Legislative Session and became effective May 1, 2002. Section 4.6.5 of that legislative rule states "every taxpayer that pays the excise tax on other tobacco products shall be allowed a discount of four percent on all tax due."

The Legislature passed Committee Substitute for Senate Bill 397, effective March 9, 2002, authorizing the Tax Department regulation. That bill, contains the following language:

ARTICLE 7. AUTHORIZATION FOR DEPARTMENT OF TAX AND REVENUE TO PROMULGATE LEGISLATIVE RULES.

§64-7-1. Tax commissioner. . . .

(d) The legislative rule filed in the state register on the twenty-third day of July, two thousand one, authorized under the authority of section five, article ten and section one, article seventeen, chapter eleven of this code, modified by the tax commissioner to meet the objections of the legislative rule-making review committee and refiled in the state register on the twenty-sixth day of November, two thousand one, relating to the tax commissioner (tobacco products excise tax, 110 CSR 17), is authorized with the following amendments:

On page 11, by adding a new subdivision 4.6.5. to read as follows: "Every taxpayer that pays excise tax on tobacco products shall be allowed a discount of 4 percent on all tax due."

And, On page 12, by striking out all of subdivision 4.7.4. and inserting in lieu thereof a new subdivision 4.7.4. to read as follows: "Every taxpayer that pays excise tax on tobacco products shall be allowed a discount of 4 percent on all tax due."

Emphasis added. See Acts of the Legislature 2002, C. 201, Page 1709 & 1710 lines 30 through 48.

Given that this specific change was enacted by the full Legislature, it represents, in effect, a statutory provision having the full force and effect of law, and such enactment

supersedes any prior in time statutory provision arguably in conflict with it. This being the case, the Tax Department respectfully submits that the 4% discount has been administered in accordance with statutory mandates.

Inventory Controls Over Cigarette Stamps and Soft Drink Stamps

During our review of the State Tax Department's (the Department) accounting procedures, we found the Department did not have an adequate segregation of duties related to the inventory controls over Cigarette and Soft Drink stamps. One employee in the Department's Excise Tax Unit maintains the inventory records for the Cigarette and Soft Drinks Tax stamps, has regular access to the stamps, and conducts the monthly inventory count of the stamps. We found no evidence that management conducts regular reviews of the employee's activities.

Chapter 11, Article 17, Section 7 of the West Virginia Code, as amended, concerning the sale and distribution of Cigarette Tax stamps, states in part:

“... Such stamps shall be kept in the custody of the tax commissioner or such deputies as he may designate to sell the same. Such stamps shall be sold and accounted for at the tax value thereof. . . .”
(Emphasis Added)

Every package of cigarettes offered for sale in West Virginia must have a West Virginia Cigarette Tax Stamp affixed to the bottom of the package as evidence the Tobacco Products Tax has been paid. Stamps are ordered by the State Tax Department from a private contractor. A large vault is used to store the majority of stamps kept on hand by the Tax Department; however, a small quantity is kept in a safe located in the vicinity of the Excise Tax Unit for the convenient retrieval of stamps by Excise Tax Unit employees when processing stamp orders from distributors. Every cigarette distributor is required to complete a Requisition Form and pay the tax when they

purchase the stamps. The tax rate is currently \$0.55 for a package of 20 cigarettes, and \$0.6875 for a package of 25 cigarettes. In accordance with State law, the distributors receive a four percent discount for affixing the stamps. Cigarette stamp sales to vendors during fiscal year 2004 were \$183,058,650.00. Proceeds from cigarette stamp sales are deposited into the State General Revenue Fund through use of the Tax Department's General Revenue Account 0470-502.

Chapter 11, Article 19, Section 5 of the West Virginia Code, as amended, concerning the sale and distribution of Soft Drink stamps, states in part:

"The commissioner is hereby authorized to promulgate rules and regulations governing the design, purchase, sale and distribution of tax stamps. . ." (Emphasis Added)

Products subject to the Soft Drink Tax include sodas, flavored milk, flavored water and carbonated water; however, pure juice, plain water and plain milk are excluded from the tax. The tax rate is \$0.01 per 16.9 ounces or less fraction thereof on each bottled (packaged or canned) soft drink. Most of the products sold in West Virginia which are subject to the soft drink tax are required to display a visible indicia on the package as evidence of tax paid. Those indicia approved by the Department include affixed crowns (e.g., metal cans), ink jet indicia (e.g., plastic bottles) and soft drink stamps (e.g., cartons). Soft drink stamps are received, stored and sold by the Tax Department's Excise Tax Unit in a similar manner as cigarette stamps. According to documents provided by the Tax Department's Excise Tax Unit, soft drink stamp sales for Fiscal Year 2004 totaled \$4,714,900.00. Proceeds from the soft drink tax are deposited into the West Virginia University's Medical Center - Education Programs Account - Account 4179-999.

As stated above, stamp inventory records are maintained by the same Excise Tax Unit employee who conducts the monthly physical inventory counts of cigarette and soft drink stamps.

This employee also conducts physical counts of stamps and reconciles these counts to the inventory records. Inventory controls are most effective when inventory counts are performed by an employee who is not responsible for processing orders, removing items from the storage area and maintaining the inventory or accounting records for those inventoried items.

Also, according to documents and interviews conducted with Department staff, 18 Department employees have access to the large vault and five Excise Unit employees of the Department have access to the small safe. We were told by Department personnel the reason a relatively large number of employees are granted access to the vault is due to the variety of items stored there. In addition to cigarette and soft drink stamps, items stored in the vault include, but are not limited to: janitor cleaning supplies, restroom paper products, and criminal investigation files. Internal controls over inventories would be more effective if access to the vault restricted to a single Department employee with provisions made for an appropriate number of alternate employees. Such procedures would permit the Department to assign responsibility for the security of those items stored in the vault.

We recommend the Department comply with Chapter 11, Article 17, Section 7 and Chapter 11, Article 19, Section 5, as amended, of the West Virginia Code. We also recommend the Department establish inventory procedures for cigarette and soft drink stamps that incorporate segregated duties for custody of the stamps, record keeping and inventory verification counts.

Department's Response

Inventories for cigarette and soft drink tax stamps are maintained manually in Excel spreadsheets. The spreadsheets contain formulas that calculate remaining inventory after the quantities of stamps issued are entered. There is one employee assigned to issue stamps;

however, if that employee is absent, someone else from the Excise Unit will issue the stamps. The employee assigned to issue the stamps enters the information into the inventory spreadsheet on a daily basis. In the absence of that employee, the Unit Manager will enter the information into the spreadsheet. To ensure that only the Unit Manager or the employee assigned to issue stamps is maintaining the spreadsheet, the Unit Manager has protected the spreadsheet with a password that has been given only to the employee assigned to issue stamps. Other employees may read the spreadsheet but will not be able to make any changes.

To facilitate inventory control, the Department has implemented the following procedures for verifying inventory of cigarette and soft drink tax stamps located in the safe as well as the vault.

- *Daily – once the stamps are issued, an employee from the Excise Unit (not assigned to issue stamps) will verify the inventory in the safe, which is located within the Unit.*
- *Monthly – under supervision of the Unit Manager, an employee (not assigned to issue stamps) from the Excise Unit will verify the inventory in the vault, located in the basement of the Revenue Center.*

To make internal controls over inventory more effective, the Department will implement the following procedures:

- *The combination of the vault will be changed.*
- *Once the combination has been changed, access will be limited to 6 employees. Due to the contents of the vault, restricting access to one employee would not be feasible.*
- *A logbook will be kept in the vault. Any employee that enters the vault will enter their name, time in, time out, and reason for the visit to the vault.*

- *Once a month, the Director of the Revenue Division will review the logbook to ensure security of the items stored in the vault.*

Accounts Receivable Records for Beer Barrel and Wine Liter Taxes.

The State Tax Department does not maintain accounts receivable ledgers for Beer Barrel and Wine Liter Taxes. Therefore, in order to provide us with a total accounts receivable balance, it was necessary for the Department's Excise Tax Unit to calculate an accounts receivable balance by obtaining individual assessments from electronic copies of lien and assessment letters mailed to individual delinquent taxpayers. Once this process was completed, we were told the total outstanding receivable balance for Beer Barrel and Wine Liter Taxes as of June 9, 2005, was \$214,528.64. Another \$232,460.23 in tax, interest and penalties for Wine Liter Taxes had been assigned to the Compliance Division for collection.

According to the Excise Tax Unit Supervisor, accounting and tax form data records for Beer Barrel and Wine Liter Taxes are fully maintained within the Internal Auditing Division's Excise Tax Unit. In order to determine what particular company has been assessed and the amount of the assessment, the electronic file must be opened and the assessment letter read. According to a Excise Tax Unit employee, electronic files of assessment letters that have not been paid are placed in a computer file folder titled "ACTIVE." If a receivable has been paid or if an unpaid receivable has been forwarded to the Compliance Division for collection, the electronic file name is changed to reflect the payment and the file is moved to an "ARCHIVED" computer folder. We noted, however, that 18 of the 68 file names in the archived folder did not clearly indicate the status of the receivable.

Chapter 11, Article 10, Section 5 of the West Virginia Code, as amended, states:

“The Tax Commissioner shall administer and enforce each tax to which this article applies and, in connection therewith, shall prescribe all necessary forms.” (Emphasis Added)

The method used by the Department to monitor accounts receivable balances for Beer Barrel and Wine Liter Taxes is confusing, inefficient and prone to error. As a result, we believe there is a significant risk of accounts receivable recording errors and possible employee misappropriation of accounts receivable payments.

The newly appointed Excise Tax Unit Supervisor said she was unaware of the Unit’s method of recording Beer Barrel and Wine Liter Tax receivables until we asked the Supervisor to describe how these receivables were monitored. Afterwards, the Supervisor told us the Unit needs to develop a better method of recording and tracking Beer Barrel and Wine Liter Tax receivables.

We recommend the Department comply with Chapter 11, Article 10, Section 5 of the West Virginia Code, as amended. We further recommend the Department establish an effective accounts receivable system for Beer Barrel and Wine Liter Taxes.

Department’s Response

The Department began administration of the Beer Barrel and Wine Liter Taxes around 1989. The accounts receivable system maintained by the Department did not have the capability to accept new tax types. Therefore, these taxes have been administered manually.

For the past three years, there have been only 27 Notices of Assessment issued for Wine Liter Tax totaling \$419,184.07 (including interest and additions to tax). Only five of those Assessments advanced to a Notice of Tax Lien and only one advanced to a Distress Warrant, the remainder was paid in the Assessment stage. These billings were issued for not remitting tax on

shipments to distributors, failure to file a Wine Liter Tax Return (these would be estimated billings), no remittance, or late filing.

For the past three years, there have been four Notices of Assessment issued for Beer Barrel Tax totaling \$43,710.76 (including interest and additions to tax). Only one of those Assessments advanced to a Notice of Tax Lien and it advanced to a Distress Warrant. These billings were issued for late filing, or failure to file a Beer Brewer Tax Return.

The Department has determined that there are tax types in the Accounts Receivable System (AREC) that are no longer used, i.e. GSC7 and GSC8. Therefore, The Department will give consideration to adding Beer Barrel and Wine Liter taxes to the accounts receivable system under these tax types with the appropriate controls to indicate that the documents generated will reflect the appropriate tax type.

Estimated Payments of Health Care Provider Taxes

While documenting the controls over the Health Care Provider Tax revenues, the Supervisor for the Tax Department's Excise Tax Unit informed us the Department does not monitor health care provider estimated tax returns for underpayment of estimated taxes and, therefore, does not impose interest on provider underpayments or late payments of estimated taxes. According to State law, health care providers must either remit at least eleven-twelfths of the total health care provider taxes due for the tax year with their estimated tax returns when tax liabilities are reasonably expected to exceed \$50.00 per month, or pay interest on the underpayment. We were unable to determine the number of estimated healthcare tax remittances with underpayments, if any, or the amount of foregone interest charges.

Chapter 11, Article 27, Section 24, of the West Virginia Code, as amended, which requires certain health care providers to remit estimated payments, states in part:

“...Every person subject to a tax imposed by this article must make estimated tax payments for a taxable year in which such person’s tax liability can reasonably be expected to exceed fifty dollars per month. Eleven twelfths of such person’s estimated tax liability must be remitted in monthly installment payments during that tax year”
(Emphasis Added)

Also, Chapter 11, Article 10, section 18b, of the West Virginia Code, as amended, states in part:

“...If a person required to make monthly or quarterly installment payments of any annual tax administered under this article...of this chapter fails to timely remit any installment payment or such tax or remits less than the amount of the required installment payment of such tax, there shall be added to the tax due for the taxable year an amount determined by applying the rate established under section seventeen or seventeen-a...of this article...”
(Emphasis Added)

Plus, Chapter 11, Article 10, Section 17(a), of the West Virginia Code, as amended, states in part:

“...Underpayments. – If any amount of a tax administered under this article is not paid on or before the last date prescribed for payment interest on the amount at the rate of eight percent per annum shall be paid...from the period beginning on the first day of July, or from the last day prescribed for payment, whichever is later, to the date paid, regardless of when the liability for the tax arose...and after the first day of July, two thousand two, interest on underpayments shall be paid at an annual rate of one and one-half percent above the annual rate established under section seventeen-a of this article...” (Emphasis Added)

In addition, Chapter 11, Article 10, section 3, of the West Virginia Code, as amended, states in part:

"...The provisions of this article apply to the...health care provider tax... administered by the tax commissioner..." (Emphasis Added)

Lastly, Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended, states in part:

"The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any other articles of this chapter to which this article is applicable..." (Emphasis Added)

Health care providers are required to file monthly estimated tax returns when tax liabilities are reasonably expected to exceed \$50.00 per month for the first 11 months of the year and an annual tax return for the twelfth month of the year for Health Care Broad Based Tax and Health Care Severance Tax. Credit is given towards the annual taxes due, as reported on the providers' annual return, for each estimated payment remitted. The Supervisor for the Department's Excise Tax Unit stated that as of June 22, 2005, there were 4,183 providers subject to the Health Care Broad Based Tax and 137 providers subject to the Healthcare Severance Tax. The amount deposited (less refunds) for Health Care Provider taxes in the Medicaid State Share Account - Account 5090 was \$152,664,888.35 and \$145,282,788.94 for fiscal years 2004 and 2003, respectively.

The Health Care Tax Accounting System and the Business Tax Accounting System are not capable of assessing interest for underpayments or late payments of estimated healthcare taxes. Therefore, the Excise Tax Unit must audit the health care provider tax returns manually in order to identify underpayments or late payments and assess interest charges.

We were told by the Supervisor of the Excise Tax Unit that due to the large number of Health Care Provider tax returns in relation to Excise Tax Unit employees, the Unit does not

verify if remittances made in conjunction with health care provider estimated tax returns meet the minimum remittance requirement imposed by State statute. Consequently, we believe there is a risk that the Tax Department is not collecting all taxes when due, and not assessing and collecting interest for late payments.

We recommend the Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended. We further recommend the Department establish and enforce a procedure whereby health care provider estimated tax returns are monitored for underpayments of estimated taxes and assessed penalties for late payments and underpayments in accordance with State law.

Department's Response

The Healthcare Provider Tax system was being developed in or around 1998. As the system was ready to begin operation, a decision was made to eliminate the underpayment penalty function on late filed or late paid monthly estimated returns for the first year. The Department has continued to function in this manner since the system was developed.

A user request has been submitted to the Networking Division to implement the underpayment penalty function. The Healthcare Provider Tax system will identify underpayments and late payments of estimated returns, and impose the appropriate interest.

There are approximately 3,700 taxpayers filing annual Healthcare Provider Tax returns in the month of December. Because the underpayment penalty has not previously been assessed and the large volume of taxpayers that may have already failed to file a monthly estimated payment or may have filed late in 2005, the implementation of the underpayment

penalty will not be effective until January 1, 2006. A notice to the taxpayers will be mailed in October regarding the implementation.

The Healthcare Provider Tax system monitors the filing and payment of estimated tax returns by calculating the total amount of tax paid and comparing to the total reported by the taxpayer on their annual return.

Late Deposits

While documenting the Department's procedure for receipts processing, we discovered the Department did not deposit all revenues within 24 hours of receipt, as required by State law. Although the Department did deposit the majority of revenues promptly, the Department's Receipts Processing Supervisor told us "miscellaneous split" receipts are deposited, on average, twice per week.

According to documents we reviewed, the Tax Department deposited \$105,457,012.54 and \$134,634,089.67 in Fiscal Years 2004 and 2003, respectively, in "miscellaneous split" receipts. The average time elapse between each deposit for the two-year period was 3.4 days.

A "miscellaneous split" receipt is when multiple types of taxes are paid with one payment instrument. For example, a receipt is considered a "miscellaneous split" if the taxpayer remits only one check to pay both consumer sales taxes and income withholding taxes. Although, it could not be determined definitively, it can be reasonably estimated that at least half, or approximately \$220,000,000.00 for fiscal years 2004 and 2003, was not deposited within 24 hours of receipt.

Chapter 12, Article 2, Section 2 of the West Virginia Code, as amended, states in part:

“(a) All officials and employees of the state authorized by statute to accept moneys due the state of West Virginia shall keep a daily itemized record of moneys so received for deposit in the state treasury and shall deposit within twenty-four hours with the state treasurer all moneys received or collected by them for or on behalf of the state for any purpose whatsoever.” (Emphasis Added)

In addition to lost interest revenues, the State is denied access to tax revenues until such time as the receipts are deposited into State accounts. Also, there is an increased risk of receipts being lost or misappropriated when they are not deposited promptly. According to Department's Receipts Processing Supervisor, miscellaneous split receipts are batched separately and since there are relatively few of these kinds of receipts, they are not processed and deposited every business day.

Additionally, the Department will occasionally receive payments by check or money order with no accompanying tax forms or remittance coupons. As a result, the Receipts Processing Section has no basis for recording the payment in the receipts processing system. When this occurs, Receipts Processing Section personnel will attach the payment to a cork board located in the Tax Department's Receipts Processing Section until the corresponding tax form or coupon is located or received. According to Receipts Processing personnel, one or two checks or money orders per day are received without tax forms or coupons.

If a corresponding tax form or coupon is not located or received within approximately one week of the Department's receipt of a payment, Receipts Processing personal will forward the check or money order to the Tax Department's Personal Income Tax Prep Unit for investigation. The Prep Unit will investigate in order to determine the proper tax against which to apply the

payment. Once this determination is made, the check is returned to Receipts Processing for deposit. According to Receipts Processing personnel, any check in excess of \$10,000.00 without a tax form is immediately forwarded to the Prep Unit for deposit determination.

We believe payments received without a corresponding coupon should be deposited within 24 hours of receipt in order to reduce the chance of these receipts being lost or stolen. Once a determination is made as to the proper taxpayer account and the tax, against which the receipts should be credited, the receipt can be properly credited and the necessary accounting entries made.

We recommend the Department comply with Chapter 12, Article 2, Section 2 of the West Virginia Code, as amended, and deposit tax payments within 24 hours of receipt.

Department's Response

The Legislative Auditor's report recommends that the Department comply with Chapter 12, Article 2, Section 2 of the West Virginia Code, as amended, by ensuring that tax payments are deposited within 24 hours of receipt.

The Department accepts the recommendations of the Legislative Auditor and provides the following information relating to the recommendations and the actions taken by the Department to address these findings.

In relation to the deposit of receipts referred to as "miscellaneous splits," the Department has stopped the practice of only processing these type transactions twice a week. Effective August 1, 2005, the Receipts Processing Section began depositing checks representing these type transactions on a daily basis.

Further, the report discusses a practice of "cork boarding" stray checks that do not have an accompanying tax form or remittance coupon. This has occurred only for checks found

in the Remittance Processing Section as they are processing payments and tax returns. Stray checks found while opening mail are immediately sent to the Personal Income Tax Prep Unit for investigation and identification. This practice was initiated in order to eliminate erroneous billings documents from being issued by the Department's billing systems when the taxpayer's payment was processed separately from the taxpayers tax return. Based upon the recommendation of the Legislative Auditor, the Receipts Processing Section will stop this practice effective August 1, 2005, and will immediately forward such checks to the Personal Income Tax Prep Unit for investigation, preparation of a remittance document(s) and subsequent deposit.

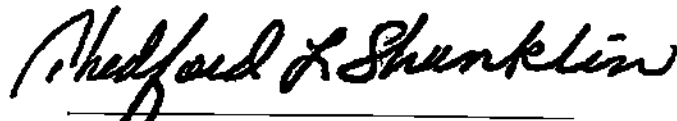
The Department has been working on new, permanent solutions to both of these issues. The Department is currently working with IBM Corporation, under an approved State Purchase Order, to install a new integrated remittance processing/data capture system. The system is currently scheduled to be installed and operational by December 16, 2005. The Department has worked with IBM to streamline and improve the processing of "miscellaneous split" transactions so that we can speed up the processing of these items within the new system. In addition, the Department has worked with IBM to establish a "check only" deposit process within the new remittance system so that we can deposit stray checks without an accompanying remittance form (tax return or coupon) upfront. This will allow the Department to deposit these "stray checks" immediately and make a post deposit decision as to which taxpayer account to credit the payment.

STATE OF WEST VIRGINIA

OFFICE OF THE LEGISLATIVE AUDITOR, TO WIT:

I, Theodford L. Shanklin, CPA, Director of the Legislative Post Audit Division, do hereby certify that the report appended hereto was made under my direction and supervision, under the provisions of the West Virginia Code, Chapter 4, Article 2, as amended, and that the same is a true and correct copy of said report.

Given under my hand this 3rd day of October 2005.



Theodford L. Shanklin, CPA, Director
Legislative Post Audit Division

Copy forwarded to the Secretary of the Department of Administration to be filed as a public record. Copies forwarded to the West Virginia Department of Tax and Revenue; West Virginia State Tax Department; Governor; Attorney General; State Auditor; and, Director of Finance Division, Department of Administration.