

Report on Compliance Programs, Activities, Trends and Targets
Prepared in Accordance with Act 50, Sec. E. 111 (b) of 2013

January 15, 2014

Vermont Department of Taxes: Report on Compliance Programs, Activities, Trends and Targets

The Vermont Department of Taxes' (the Department) mission is to collect the proper amount of tax in a timely manner. The Department largely relies on voluntary compliance, supported by audit and collection activity that is relatively small in scope but essential to collecting the right amount of tax from the maximum number of taxpayers. The Department's current strategic vision is to enhance voluntary compliance through transparent policy development, education, and outreach. At the same time, the Department seeks to thoroughly modernize its audit and processing functions, to ensure that there is a level playing field for all taxpayers and sufficient enforcement to deter tax avoidance. Finally, the Department would like to explore with the Legislature best practices from other jurisdictions related to collection policies and strategies.

In accordance with Act 50, Sec. E. 111 (b) of 2013, this report details the programs, activities, and trends of the Department's Compliance Division. The report is comprised of four sections: 1) an overview of the Compliance Division including discussion of the historical audit process; 2) modernization of audit and compliance techniques and current programs; 3) anticipated changes to compliance and collections with the move to an integrated tax system; and 4) long term need for additional, best practice collections tools as internal processes are optimized.

1) Overview of the Compliance Division

The Vermont Department of Taxes Compliance Division is comprised of three sections:

1. Office Audit performs audits on both individuals and businesses from the Montpelier location. They also follow-up on leads generated by the Data Warehouse, which is discussed below.
2. Field Audit performs complex audits, generally of businesses, that require an auditor to go to the taxpayer's location to review records and business processes. There are two teams of field auditors that divide the state into north and south regions.
3. Compliance is responsible for both collection of outstanding debt and for bringing businesses into compliance by following up to ensure they file their trust tax returns in a timely manner.

Audits are one of the chief functions of the Compliance Division. They are used to find non-filers, discrepancies, and errors. Audits are selected through a variety of criteria. Traditionally, audits were selected through the manual review of information such as W2s, Federal Audit results shared by the IRS, the comparison of State and Federal returns, individual tips, or known compliance issues in an industry. The research needed to simply find cases worth pursuing has been very time intensive, limiting the quantity of reviews. The Department has made great strides in the past few years in improving the efficiency of our work, which will be discussed in the second section of this report, Modernization Efforts.

The other primary function of the Compliance Division is collecting tax debts owed to the State of Vermont. The collection process at the Department is founded on a progressive discipline doctrine. The Department starts with low key efforts and, if those are not successful, the efforts

gradually become more aggressive. Cases have historically been selected based solely on the amount owed and were assigned by a supervisor. This is another area where modernization has led to significant improvements in the efficacy of the Department's work.

2) Modernization Efforts

Data Warehouse

In 2007, the Department created the Labor Data Matching Program to compare wage data from the Department of Labor and return information from the IRS against taxpayers' Vermont individual income tax return. This greatly helped the Department identify non-filers and under-reporters, but was limited in scope and capacity. Seeing the success of this fairly limited, internal project, the Department turned to outside vendors to find more comprehensive data analytic tools.

In May 2011, the Department entered into a contract with Revenue Solutions Inc. (RSI) to construct a data warehouse. The Data Warehouse was designed to compile available data from taxpayers (such as wage and income reports, addresses, registrations, licenses, etc.) and is enhancing the Department's ability to find non-filers, detect refund fraud, reconcile discrepancies between state and federal returns, improve audit selection, and score collections cases. The performance of this project is measured through a "lift," the amount of money raised over historical baselines that are agreed upon by Tax, the Department of Finance, and RSI. The Data Warehouse is projected to collect \$16.1 million in otherwise unpaid taxes over five years and has generated over \$5.4 million to date.

The Data Warehouse has and will increase collections by changing the way the Compliance Division works. By automating the selection of audits, more data is able to be factored into the process resulting in fewer false positives. Additionally, when Data Warehouse programs are run, such as the search for non-filers, the Department is able to adjust the program throughout the lifespan of each project. We review feedback from taxpayers and statistics on refuted assessments, subsequently making any changes to increase the number and quality of leads. This has been highly successful as evidenced by the increased collections generated with a relatively level number of staff.

The Warehouse has begun processing many of the non-filer, discrepancy, and adjustment cases, issuing bills previously generated by desk auditors. This has led to previously undiscoverable cases and automated much of the initial research to find leads. The Data Warehouse will allow us to develop queries to look at what types of field audits were most successful and appropriate in the past. This will require a close look at our past practices, analyzing both our successes and cases with less than optimal results. Using this information, the Warehouse can do a more efficient job of audit selection.

Another major improvement the Data Warehouse has brought is through the Collection Process Improvements Program. This program scores a taxpayer's likelihood to pay their debt. This score is then used to apply the most appropriate collection treatment based on the risk of non-payment. By applying the best collection approach based on the taxpayer risk, the Department can apply

its collection staff resources to the cases that require human intervention. Conversely, if a taxpayer is a low risk and has a high likelihood of payment, there is no need to use collection resources. This approach increases the overall effectiveness of the collection operation as the Department is able to deploy its resources to the right case at the right time.

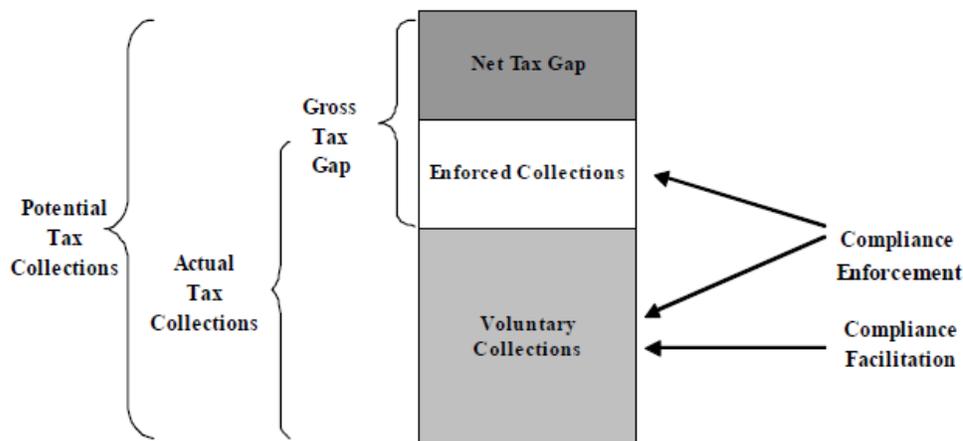
By comparing a historical monthly baseline to the performance achieved after the collections initiative has been implemented, the Department is able to measure the value of the program. From October 2012 through November 2013 we have increased collections by \$3,357,884 from the Collection Process Improvements Program alone.

Another initiative, started in February 2013, used the Data Warehouse to identify taxpayers who were neither making payments nor being actively pursued but earned enough wages to be making payments. Letters were sent advising these taxpayers to arrange a payment plan or the Department would pursue a judgment and wage garnishment. Those contacted who did not comply and are currently employed have been fast tracked for judgment or wage garnishment. This project is helping our legal staff identify taxpayers we have judgments against and should pursue wage garnishment against as well. To date, this program has resulted in the collection of \$199,322.39 from accounts that were for one reason or another inactive.

Voluntary Compliance: Outreach and Education

The foundation of our revenue system is voluntary compliance; as with other laws, we rely on taxpayers to educate themselves as to their tax liabilities, and to file and pay the correct amount of tax. In order to close the tax gap—the difference between taxes rightfully due and taxes actually paid—it is essential that the Department focuses on increasing both voluntary collections and enforced collections.

Figure 1. The Tax Gap and Tax Administration Measures



In 2012, the Department re-deployed positions, including auditors, to create a new Policy, Outreach, and Legislative Affairs (POLA) Division. This Division, including new policy

¹ Figure 1 Citation: Brondo, John, Carlos Silvani, Eric Le Borgne, and Frank Bosch. "Tax Administration Reform and Fiscal Adjustment: The Case of Indonesia (2001-07)." *IMF Working Paper* 08.129 (2008): 19. <http://www.imf.org/external/pubs/ft/wp/2008/wp08129.pdf>.

analysts and tax education specialists, focuses on outreach. POLA is charged with ensuring that the Department develops correct, consistent, and clear positions in its administration of tax law, and that it conducts campaigns to educate the public. In the first year of operation alone, the Division had already been responsible for the formation of two advisory boards, the staffing of over a dozen trade group gatherings (such as the Farm Show), and the drafting and dissemination of new educational materials on subjects ranging from the rooms tax to application of sales tax for contractors.

The work of the POLA Division represents a fundamental shift in the nature of traditional compliance efforts. Most compliance efforts are reactive, generated when a taxpayer fails to file or underreports. The outreach and education staff must be proactive, seeking taxpayers on their own terms to provide them the information needed to ensure they are able to comply with tax laws. POLA and Compliance are working closely to identify areas of the tax code that taxpayers frequently misunderstand.

The collaboration between audit and education staff is demonstrated through the response to Act 73 of 2013. Act 73 directed the Department to develop and pursue further strategies and redeploy resources to close the tax gap during fiscal year 2014 by increasing current collections by \$1,500,000.00. The Compliance and POLA divisions developed several initiatives to achieve that target. These include a voluntary disclosure program, rooms tax compliance, and several data matching programs.

The Department has always been open to voluntary disclosures, also known as “come forwards.” However, through the increased collections initiative directed by Act 73, the Department has worked to formalize the process. The POLA Division is currently piloting a voluntary come forward program in collaboration with audit staff, titled “Know What You Owe.” The concept is to develop targeted educational materials highlighting areas of known non-compliance, and offer a limited time for vendors to come forward for a voluntary audit, with forgiveness of penalty and partial interest covering a three year period. This initiative is encouraging voluntary compliance by helping taxpayers understand the law and leveling the playing field between retailers who have been charging the correct tax and those that have been enjoying the competitive advantage, even if inadvertent, by failing to collect tax properly.

3) Anticipating the ITS

Central to the success of outreach, education, and compliance efforts is the Department’s ability to continue to modernize its tax processing systems. A modern integrated tax system (ITS)--a streamlined electronic platform that handles all aspects of the taxpayer interaction, including forms, registration, filing, payment, processing, correspondence, billing and collection--will create efficiencies throughout the Department and help taxpayers. An ITS offers a single view of the taxpayer, greatly enhancing the Department’s ability to provide modern customer service, accurate accounting, and essential security, as well as to analyze data and maximize audit initiatives.

Just as the Data Warehouse was able to improve work selection and create efficiencies by reducing manual processes, the ITS will extend that functionality to the whole Department. The

Department has finalized a contract with FAST Enterprises to implement their ITS software, called GenTax. This software has a proven track record, with full implementations in over sixteen states, all of which came in on schedule and on budget.

Similar to the Data Warehouse, this contract will also be benefits based and will lead to increased efficiencies in audit selection as well as general processing improvements. Just as cases for collections staff are scored to determine selection and refunds are reviewed based on other scoring criteria, the new ITS will be able to analyze and target the work of the Department. Moving all of our processing systems into a single unified system will greatly improve reporting capabilities and seamlessly find tax gaps that were previously unable to be found.

Not only will the ITS improve internal work, it will also improve the Department's communication with taxpayers. The ITS comes with the functionality for taxpayers and preparers to look up their accounts, pay bills, and see notices from the Department online, similar to online banking. This serves to not only greatly enhance our customer services capabilities, but supports increased voluntary compliance by offering taxpayers easy, seamless ways to interact with the Department.

4) Modernizing Collection Tools

The Department's efforts to promote voluntary compliance and modernize its audit and tax processing strategies can be viewed as complementary carrot and stick approaches to reducing the tax gap. The final piece of the puzzle is collection tools, the strategies that the Department uses to pursue and receive payment from truly recalcitrant taxpayers. Some of the current tools include assessing penalties and interest, sending written notices, direct contact by Department staff, bonds, liens, and the ability to set court ordered judgments and wage garnishment. However, the Department's research reveals that other states generally have stronger tools in tax collection. There are several "best practice" collections tools that Vermont could implement with legislative approval. As the final piece of a comprehensive strategy, these tools have the ability to transform the way the Department reduces the tax gap. These include:

- Administrative Judgments in Uncontested Cases for Wage Garnishments and Bank Levies
- Collection Fees
- Published Top Delinquency Lists
- Treasury Offset and Reciprocal Agreement

Administrative judgments would allow the Department to garnish wages or levy a bank account for a delinquent taxpayer through an internal process. Importantly, just as the Department does now, levies and garnishments could not be sought unless a debt was fixed without any further rights of the taxpayer to appeal. For example, the Department may have identified a non-filer, sent multiple notices of an assessment and appeal rights, and still have no response from the taxpayer. Statute eventually fixes that debt. The current procedure for then garnishing wages or levying bank accounts requires Department attorneys to file a civil suit against the taxpayer in order to obtain a judgment. This extra step in the process gives taxpayers a further opportunity to move funds before they can be garnished or levied.

Currently, the significant cost of collections work is being shared by taxpayers that require the use of collection efforts and by taxpayers that are complying with their tax obligations without the Department using active collection efforts against them. Some states impose a collection fee, above any standard interest and penalty, on taxpayers that require collections efforts beyond an initial bill or the setting up of a payment plan. This could be an additional tool to incentivize taxpayers to pay their tax bills.

To ensure ongoing compliance, a tax delinquency list exists for approximately half of the states. This is a list, available to the public, with the name and outstanding tax liability of individuals that have a tax delinquency. Different states have different thresholds for their lists, be it number of individuals or amount of debt. These lists function in the same manner as delinquent taxpayer lists for municipal property taxes.

In conjunction with the U.S. Department the Treasury and Vermont's Department of Finance and Management, the Tax Department is exploring an additional Treasury Offset Program known as the State Reciprocal Program which would make all state debt eligible for offset against Federal payments. This would include payments to Federal vendors. Other States have seen significant boosts in collections from this program. The Department intends to ask for the necessary statutory language in the 2014 session.

The implementation of an ITS will optimize the Department's operations and help identify recalcitrant taxpayers. In order to efficiently collect on these found monies, the Department will need to keep up with industry best practices with modern collections tools. Streamlining internal operations is an essential precursor to implementing potential tools and will allow the Department to utilize these new tools appropriately.

Conclusion

The Department of Taxes, in its commitment to collecting the correct amount of tax, has made important strides over the past decade to modernize tax collection and compliance. This, part of a three-pronged approach of enhancing voluntary compliance, increasing enforcement through modernized audit and processing, and instituting effective collect measures has opened the door to greater efficiency and increased accuracy in audit selection. The forthcoming Integrated Tax System will offer tools to modernize all of our systems, as well as enhanced data and analytics to measure staff performance and Department processes. These tools are complemented by increased outreach and communications that are improving voluntary compliance and fostering a greater understanding of the tax code. As the Department looks forward, we hope to build on these successes and pending improvements by seeking additional compliance tools such as administrative bank levies and garnishments. It is only through such a comprehensive approach that we will meaningfully address the tax gap to ensure taxpayer fairness through compliance with the law.