

WHO IS AUDITING THE DEPARTMENT OF REVENUE?

NO ONE.

Alabama is facing a sizable budget deficit leading us to two basic decisions: Increase taxes or decrease funding. There are solutions, but all our problems will not be cured by tax reform or government cut-backs. Every year individuals and corporations receive letters from the Department of Revenue requesting audits of their financial records. My question is, "Who's taking a close look at the operations of the Department of Revenue?"

A. Our Current Problem: Nobody Is Watching.

Who is responsible for overseeing the Department of Revenue to make sure it is enforcing our tax laws and collecting all the revenues that our schools now desperately need? By statute, the Examiners of Public Accounts, an independent legislative audit agency for the State of Alabama, audits all government departments. Their responsibility is to perform audits of all accounts of all entities receiving public funds, disbursing public funds, or possessing state owned property. The Department of Revenue, as the largest government agency receiving and distributing funds, fits this description. The Examiners of Public Accounts conducts the traditional financial and compliance

audits of the Department of Revenue every two years. In addition they perform operational audits that promote efficiency and effectiveness.

We took a closer look at the Examiners of Public Accounts audit report of the Department of Revenue for years 2000 and 2001. The report only consisted of five pages, three of which merely explained that the Department has a Commissioner appointed by the Governor collects an assortment of taxes. There were two recommendations in the audit report, one related to employee administration and another related to a reporting requirement to the Governor. The audit did not even reference if the Department was adequately collecting revenues, its most important function. Instead, only compliance of laws and regulations was looked at all. For all we know, money is walking out of the Department even if it is collected. Is this adequate assurance that our state's billing and collection department performs its duties fairly and efficiently?

The Department of Revenue is a multi-billion dollar tax collection agency with many divisions and thousands of functions that are vital to the funding of our state. Its revenues rival those

of Alabama Power and BellSouth. Any corporation with the size and complexity of the Department of Revenue would normally have ten to fifteen independent auditors auditing year round covering all aspects of the business. Are Alabamians only to count on a two page report not even looking at receipts to receive assurance that their Department of Revenue is enforcing Alabama tax laws? This is not supervision and does not meet the government's audit requirements established by the Government Audit Standards Board of the American Institute of Certified Public Accountants.

The Department of Revenue has a greater responsibility than most agencies; it is the financial life line of our state. Poor decisions made by the Department can severely damage our State's funding, rendering it insolvent. Accountability within the Department cannot be obtained by making sure office supplies are accounted for and employees are completing expense reports correctly.

The Governor and the Legislature can look directly to the Department of Revenue as the entity largely responsible for our current fiscal crisis. The Department's inability to interpret legislation and audit effectively has cost Alabama hundreds of millions of dollars in needed revenue. Our current education funding shortfall can be laid at the feet of the Department of Revenue. The

following examples are only highlights of the many inefficiencies and inadequacies we have encountered while working with the Department of Revenue.

- The Department refuses to tax Real Estate Investment Trust (REITs), despite its legal authority to do so and even though REITs are taxed by the IRS. The Department's Assistant Commissioner, Directors, and Legal Division could not come together and uniformly decide if they had the authority to tax REITs, when our tax laws clearly favored the taxation. The Department has the authority to follow Federal laws that disallow the deduction of dividends received from REITs. Each year the Department allows the statute of limitations to run on REIT related taxpayer returns costing Alabama over \$40 million annually.
- During the December 2001 Special Session our Legislature passed key legislation changing Alabama tax laws to close corporate tax loopholes. A year and half later, the Department's auditors and revenue examiners have yet to receive formal training on the new legislation that would have generated hundreds of millions in revenue that our Legislature desires. Has

the Department of Revenue decided that training our auditors on new legislation is not important? We lose revenue every time we make a poor audit selection or miss an assessment due to lack of proper training.

- The Department will not enforce our Legislature's anti-Geoffrey intangible add-back statute.

The Department has yet to audit and assess a single taxpayer wrongly deducting intangible transfers to a Geoffrey despite our new legislation specifically requiring the add-back. This is the most abusive tax avoidance mechanism used today. The lost revenue is hard to estimate, but a conservative estimate would be close to \$50 million.

- The Department has experienced poor audit selection and inefficient use of audit resources.

The Department's Out-of-state auditors spend thousands of dollars traveling to taxpayers with a final result of "Assess as Filed" or often they may increase a refund to a taxpayer. I'm not sure how they pick their audits. It could be that San Francisco is very nice this time of year, but it can be said that audits are not selected with any sophisticated method. I have

previously expressed the need for more well trained auditors coupled with better audit selection targeting Alabama's Fortune 1000. These efforts could potentially generate revenues of \$100 million annually.

- Legal decisions made by the Department's Administrative Law Judges are critical because they set the precedent for future litigation and interpretations. Failure to enforce our tax laws lets the sophisticated taxpayers know that school's out in Alabama on paying your taxes. Poor decisions favoring taxpayers have now raised ethical and judicial independence issues between our Law Judges and litigators who represent the taxpayers. Several out of bounds decisions alone total over \$30 million in the past year and hundreds of millions in previous years.

How long will we continue to allow the Department of Revenue to abuse our tax laws? Go back and add up the financial consequences of the above incompetent procedures and decisions that affect our school children daily. The Department has many problems, but at least we can attempt to

make a few changes to properly fund our state education system.

B. How to Fix the Problem: The Department of Revenue Oversight Board.

I examined how other states have corrected tax revenue collection compliance and procedural problems. Missouri encountered problems with its Department of Revenue similar to those now rampant in Alabama. The Missouri Department of Revenue's problems escalated to such a point that the Legislature was forced to pass legislation establishing a Department of Revenue Oversight Board to oversee the Missouri Department in its management, conduct, direction, execution, and application of the tax laws of Missouri. The board consists of nine members, including the Commissioner of Revenue. Each member, with the exception of the commissioner, who interestingly is appointed by the Legislature, is appointed by the Governor and serves a five year term.

Alabama should immediately create an oversight board of its own. Like Missouri's board, the Alabama Board would have the authority to review, correct and approve tax administration actions

and collection activities. If the Oversight Board, by a majority vote, determined that an action or activity performed by the Department was improper, the Oversight Board would be authorized to direct the Department to follow the corrective course of action. Alabama is no longer able to allow the Department of Revenue to continue on a frolic of its own while our schools stare bankruptcy in the face.

The Alabama Department of Revenue Oversight Board could implement an initial emergency five step plan to force and implement change within the Department. These steps will not be permanent duties and responsibilities of the Board, but will be the needed steps taken to tackle the initial grave problems the Board will encounter.

1. Address administrative problems that reduce revenue collections to Alabama.
2. Force the Department to evaluate weak interpretations related to current legislation that have reduced tax collections.

3. Force the Department to restructure the deployment of its existing 1,300 employees to adequately audit and collect existing tax owed to the State

4. Force the Department's Audit Division to change the audit process and implement as audit selection methodology to operate more efficiently and effectively. This will drastically improve audit results that will internally increase tax collections.

5. Force continued and mandatory auditor training on existing new tax enforcement and reform legislation rules, regulations, procedures and methods to increase revenue collections.

C. Conclusion: Intervention Is Long Overdue.

There are many other issues that require supervision within the Department of Revenue. Most of the Department's leadership assumes that nothing can be done to improve tax collections under our existing system. This will give hope to those who have long ago thrown up their hands in desperation, while discouraging the ones who created the problem and do everything possible to

stifle change and innovation. It is time for the State to bring this Department to ground. I used the word force in describing the initial procedural steps to bring this Department back in tow because the Department's current staff will not change overnight or on its own. We need serious intervention and it should start with the Alabama Department of Revenue Oversight Board. Only then will Alabama have a chance to right its financial ship of State.