



# *Department of Taxes Abatements of Business Tax Liabilities*

Reasons for Most Abatements Consistent with Statute, Department Policy, or Rules; Those with an Inconsistent Reason or Lacking a Documented Reason Limit Assurance of Fair and Equitable Treatment for Taxpayers



## Mission Statement

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Dear Colleagues,

The mission of the Vermont Department of Taxes (VDT) is to collect the proper amount of tax revenue owed. In some cases, the Department may choose to waive, reduce, or compromise tax liabilities that have been assessed against a taxpayer. The Commissioner has the statutory authority to make these adjustments but must document the reason(s). In the fall of 2016, our office heard from two former and one current (at the time) VDT employee who expressed concern about certain adjustments of business tax liabilities. These concerns, in addition to the large dollar amounts involved in these particular business taxes (sales and use, meals and rooms, business income, and corporate income) adjustments - \$37.6 million and \$10.7 million in 2015 and 2016 respectively - led my office to commence an audit. The audit objectives were to: 1) assess the extent to which VDT's rationale for adjusting tax liabilities through abatements and write-offs was consistent with statutory requirements and VDT policy, and 2) summarize abatements and write-offs recorded by VDT for certain business tax liabilities in calendar years 2015 and 2016.

We found that for a non-statistical sample of 59 abatements and write-offs (five of which were brought to our attention by current and former staff), the department had documented reasons that were consistent with VDT policies, rules, and statutes in most cases (36 of 59). However, we found that the method of documenting the reasons was not systematic and that codes describing the reasons for the adjustment were inconsistent with supporting documentation. This makes it difficult for management to monitor the adequacy of the reasons for the abatements and write-offs.

For some abatements and write-offs (23 of 59), we found that VDT staff either did not document any reason, cited a reason that was not consistent with VDT policies or rules, recorded a rationale that was not applicable to the taxpayer's circumstances, or documented a reason consistent with circumstances for only a portion of the total abatement or write-off. The failure to document an adequate reason limits the department's ability to evaluate whether standards for abating tax liabilities are applied consistently to provide fair and equitable treatment for taxpayers.

These problems may have arisen because the department's standard operating procedure (SOP) in place during 2015 and most of 2016 failed to address the statutory requirement for VDT to document the reasons for abatements and write-offs and what supporting documentation should be retained. A revised policy was issued at the end of 2016, but the procedure still lacks guidance about how to document the reason for abatement or write-off and does not contain definitions for the reason codes.

We also found that the former commissioner abated penalty, interest, and tax in one instance citing the taxpayer's good faith efforts to comply with tax law and a change to tax law as reasons for the abatement. However, the official letter ruling on the taxpayer's appeal concluded the tax was owed and the change to the tax

law was after the period for which the tax was owed. While the commissioner has broad statutory authority to make abatements, these circumstances were not found in VDT policies or rules. To the extent similarly situated taxpayers paid tax in accordance with the law prior to the change, the abatement of the tax for this one taxpayer means that not all taxpayers were treated equitably.

We found that several of the abatements and write-offs were due to settlements with taxpayers. VDT rules require the evaluation of five factors, such as equity among taxpayers and risk of litigation, when considering a settlement. VDT asserted that the factors were considered but that there was no requirement for the process to be documented, and therefore they could not provide us with evidence of the evaluation. Without documentation of the evaluation, the department cannot show compliance with their rules.

We found that many of the abatements were approved by staff not authorized to do so, as per the SOP, but were accepted by the IT system. This is likely due to a mismatch between authorization levels required by the SOP and authorization levels established in the department's IT system. If left uncorrected, the department will not have assurance that transactions are executed by the employees designated by management via the procedure document. There is also a risk that unwarranted transactions could occur.

For objective two, we analyzed data extracts from the department for calendar years 2015 and 2016 for certain business taxes. Several limitations in the data led us to conclude that the data could not be relied upon. Because of this, the information in the extracts cannot be used to summarize abatements and write-offs in these years. Problems found with the data include transactions recorded as abatements that were not abatements, the classification of transactions as either abatements or write-offs was not meaningful, and transactions not recorded in the correct time period.

We also found that at the time of the transition to a new IT system, VTax, there was a backlog of 32,000 unprocessed corporate and business income tax returns, an issue that originated in 2009 with the previous tax system. For many of these backlogged returns, VDT had not timely assessed tax liabilities and could not pursue collection because of time limitations in statute. It's not known how much of these tax liabilities would have been collected had VDT timely processed these returns and identified the tax liabilities prior to the statutory deadline.

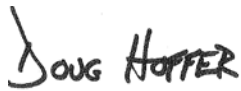
Finally, we followed up on two audits based on staff concerns that the former commissioner had interfered in the audits. There is no evidence that the former commissioner interfered in the audits. The department ultimately did not issue an assessment for one of the audits because VDT's policy group determined that the law associated with the particular tax was ambiguous in some areas and required modernization in others. We also reviewed a refund allowed by the former commissioner but staff were concerned was not consistent with the law. However, ambiguity in the same law, relevant to the audit, was highlighted in a department policy memo that addressed the refund. The policy memo suggests

that the appropriate course of action is to propose changes to the law. SAO reviewed the current version of the law and no changes have been made to address the issues pointed out in the policy memo.

We made a variety of recommendations to the Commissioner, including implementing guidance to address how to document the reasons for abatements and write-offs and to remedy the discrepancy between authorization levels in the operating procedure and in the IT system. We recommended one matter for the Legislature to consider, requiring that the five-factor evaluation for settlements be documented.

I would like to thank the staff at the Department of Taxes for their cooperation and professionalism during this audit. This report is available on the state auditor's website, <http://auditor.vermont.gov/>.

Sincerely,



DOUGLAS R. HOFFER  
State Auditor

ADDRESSEES

The Honorable Mitzi Johnson  
Speaker of the House of Representatives

The Honorable Tim Ashe  
President Pro Tempore of the Senate

The Honorable Phil Scott  
Governor

Ms. Susanne Young  
Secretary, Agency of Administration

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# Introduction

The mission of the Vermont Department of Taxes (VDT) is to collect the proper amount of tax revenue in a timely and efficient manner to pay for the goods and services provided by state government. In some circumstances, it may be reasonable to waive, reduce, or compromise taxpayer tax liabilities.<sup>1</sup> The VDT Commissioner has the statutory authority to make these adjustments, although the reason for adjusting tax liabilities must be documented. In calendar years 2015 and 2016, VDT abated \$37.6 million and \$10.7 million, respectively, of corporate income, business income, sales and use, and meals and rooms taxes. Per the State's revenue report for fiscal year 2016, the total amount of corporate income, sales and use, and meals and room taxes collected was \$641.9 million.<sup>2</sup>

According to VDT's current abatement and write-off standard operating procedures (SOP),<sup>3</sup> grounds for abating interest and base tax are limited to extraordinary circumstances, but there are many instances where abatement of penalty may be warranted. The procedures emphasize the importance of applying standards and criteria consistently throughout the department to provide fair and equitable treatment for taxpayers. The National Conference of State Legislatures reports that if tax systems are administered fairly, individuals and businesses are more likely to pay their rightful share of the tax burden. In its tax concept statement, Guiding Principles for Tax Equity and Fairness, the American Institute of Certified Public Accountants indicates that compliance should improve with a perception that most taxpayers are complying and those who do not comply experience adverse consequences.

In the fall of 2016, two former and one current VDT employee (at the time) expressed concerns to our office about VDT practices related to adjusting tax liabilities. These concerns and the level of abatements in 2015 and 2016 led us to commence an audit to: 1) assess the extent to which VDT's rationale for adjusting tax liabilities through abatements and write-offs was consistent with statutory

<sup>1</sup> Tax liability includes the liability for all amounts owed by a taxpayer to the State of Vermont under Title 32 of Vermont Statutes Annotated. Liabilities include tax, interest, penalties, and fees.

<sup>2</sup> This report does not disclose business income tax as a separate item, but VDT indicated that it was included with corporate income tax.

<sup>3</sup> SOP 2016-02, effective December 13, 2016, defines an abatement as the reduction in whole or in part of a monetary amount legally due the department and a write-off as the removal of a monetary amount which VDT no longer has the authority to collect.



requirements and VDT policy and 2) summarize abatements and write-offs recorded by VDT for certain business tax liabilities in calendar years 2015 and 2016. During the course of the audit, the Department of Taxes disclosed that it did not distinguish between abatements and write-offs prior to December 13, 2016, when SOP 2016-02, "Tax Liability Abatements and Write-Offs," was implemented. According to the department, "Under the previous SOP, abatements and write-offs were used interchangeably." For purposes of this audit report, we refer to all adjustments of tax liabilities included in the scope of our audit as abatements because the department did not distinguish between the two terms and because the SOP in effect during 2015 and most of 2016 was named "Tax Liability Abatements."

Appendix I contains detail on our scope and methodology. Appendix II contains a list of abbreviations used in this report.

# Highlights

According to data provided by VDT, in calendar years 2015 and 2016 the department abated \$37.6 million and \$10.7 million, respectively, of corporate income, business income,<sup>4</sup> sales and use, and meals and rooms tax liabilities. In the fall of 2016, one current and two former employees expressed concerns to our office about VDT practices related to abatements of tax liabilities. These concerns and the level of reductions to tax liabilities in 2015 and 2016 led us to commence an audit to: 1) assess the extent to which VDT's rationale for adjusting tax liabilities through abatements and write-offs was consistent with statutory requirements and VDT policy and 2) summarize abatements and write-offs recorded by VDT for certain business tax liabilities in calendar years 2015 and 2016.<sup>5</sup> During the course of the audit, the Department of Taxes disclosed that it did not distinguish between abatements and write-offs prior to December 13, 2016. Accordingly, for purposes of this audit report, we refer to the adjustments of tax liabilities as abatements.

## Objective 1 Finding

The VDT commissioner has broad statutory authority to waive, reduce, or compromise taxes, penalties, interest or other charges or fees within VDT's jurisdiction but must document the reason for adjusting these tax liabilities.<sup>6</sup> Statute, rules, and the department's abatement policy address the circumstances that warrant waiving, reducing, or compromising tax liabilities.

For 36 of 59 abatements (61 percent) totaling approximately \$3.1 million,<sup>7</sup> SAO concluded that VDT's documented reason was consistent with the department's policies for abating tax liabilities or interpretation of rules for settlements, based on

<sup>4</sup> Pass-through entities, including S-Corporations, partnerships, and limited liabilities companies (LLCs) that elect to be taxed as partnerships or S-Corps, are subject to Vermont's business income/business entity tax laws and provisions.

<sup>5</sup> The scope included all abatements that occurred in these years, regardless of the year the tax was owed.

<sup>6</sup> 32 V.S.A. §3201(a)(5)

<sup>7</sup> SAO selected a non-statistical sample of 70 abatements from calendar years 2015 and 2016. Sixteen were determined not to be traditional abatements and were excluded from further analysis. Six additional abatements were brought to the attention of SAO by current and former staff who believed the abatements were not justified, but one had already been selected as part of the non-statistical sample.

a departmental appeal ruling, or we found the department had properly cited statutory limitations on collection of tax liabilities<sup>8</sup> or bankruptcy.

We found that the method of documenting the reasons was not systematic. Some reasons were documented via a combination of reason codes<sup>9</sup> and an adjustment notes field in VTax, the department's tax processing system. Others were documented via a combination of reason codes and a variety of source documents. In addition, we found that reason codes for 20 of the 36 abatements were inconsistent with information contained in the adjustment notes field, did not reflect the actual reason for abatement that was contained within various documents, or were not specific enough to conclude that they reflected the reason for abatement (e.g., "administrative decision"). The lack of a systematic method of documenting the reasons and the limited utility of the reason codes could hinder management's ability to efficiently and effectively monitor the adequacy of the reasons for abatements.

For the other 23 abatements (39 percent) totaling approximately \$4.6 million, VDT 1) did not document a reason for abating tax liabilities, cited a reason that was not applicable to the taxpayer's circumstances, or it documented a rationale that was not consistent with VDT policy or rules (16 of 59) or 2) documented a reason that was consistent with the department's policies, rules, or statute for only a portion of what was abated (7 of 59). The failure to document an adequate reason for abatements limits the department's ability to evaluate whether standards and criteria for abating tax liabilities are applied consistently throughout the department to provide fair and equitable treatment for taxpayers, the stated purpose of the department's standard operating procedure for abating tax liabilities. In addition, there is risk that departures from policies and rules could appear arbitrary.

We also found that several abatements were settlements with taxpayers. VDT rules require the evaluation of five factors, such as equity among taxpayers and risk of litigation, when considering a settlement. Department officials told us that the five factors are considered and discussed when evaluating settlements, but there was no documentation of how each of the factors was applied. According to the VDT General Counsel, there is no requirement that the evaluation of the factors be documented, only a reason for an abatement must be documented per statute. The Department of Finance and Management's (DFM) internal control guidance<sup>10</sup> for managers indicates that documentation preserves evidence to substantiate a decision, event, transaction, or system and documentation should be complete, accurate, and recorded timely. Without documentation of the evaluation, the department lacks a record that demonstrates how VDT balanced the risk of litigation with equity among taxpayers. Further, the department does not have a

<sup>8</sup> 32 V.S.A. §5892(a), 32 V.S.A. §9812(a), 32 V.S.A. §9280(c).

<sup>9</sup> Staff must select from a pre-populated list in the reason field of the department's tax system. See Appendix III for the list of reason codes included in SOP 2016-02, "Tax Liability Abatements and Write-Offs," effective December 13, 2016.

<sup>10</sup> *Internal Control Standards: A Guide for Managers*, Department of Finance and Management.

clear record to demonstrate compliance with the rule that requires the five-factor evaluation.

The lack of a systematic approach, limited utility of reason codes, and the failure to adequately document a reason may be because the department's SOP for abating tax liabilities, applicable in 2015 and most of 2016, did not address the statutory requirement for VDT to document a reason. Further, a VTax desk guide, revised September 23, 2016, explained the procedures for recording an abatement in the VTax system, including the requirement to select a reason code, but it did not address what should be documented in the adjustment notes field in VTax. Neither document addressed what external documents, if any, should be retained to substantiate the reason code selected or information in the adjustment notes field. The department released an updated SOP December 13, 2016 which addressed the requirement to document the reason for abatement and incorporated a list of reasons to select in the VTax reason field. However, the policy still does not include guidance about how to document the reason for abatement or definitions for the reason codes.

Many of the abatements were not authorized at the requisite staff level per the department's SOP applicable in 2015 and most of 2016. This is likely due to the discrepancy that existed between requirements in the SOP and permissions for approving transactions established in VTax. Per DFM's internal control guide, authorization is the activity designed to ensure events or transactions are initiated and executed by those designated by management. The department issued a revised SOP, effective December 13, 2016, but discrepancies remain. To the extent that there continues to be inconsistency between the department's SOP and permissions established in VTax, the department won't have assurance that transactions are initiated and executed by staff designated by management and there is risk that unauthorized abatements could occur.

## Objective 2 Finding

According to data extracts from VDT's VTax system, abatements and write-offs of tax liabilities were significant in calendar years 2015 and 2016 for business income, corporate income, meals and rooms, and sales and use taxes (see Table 1). Several limitations in the VTax data led us to conclude the data in these extracts was not reliable for purposes of our audit objective. Because of reliability concerns, the information in Table 1 should not be used to draw conclusions about the total amount of tax liability abatements by VDT.

**Table 1: Abatements by Tax Type for Calendar Years 2015 and 2016, per VTax Data**

<b>Tax Type</b>	<b>2015</b>	<b>2016</b>	<b>Comments</b>
Business Income	\$26,007,338	\$3,307,694	At least \$24.2 million <sup>a</sup> and \$2.5 million of the abatement of business income tax (BIT) in 2015 and 2016, respectively, represented reduction of tax liabilities related to nonresident withholding (NRW). <sup>b</sup> SAO utilized data points in the VTax data extracts to identify which BIT abatements were related to NRW, to the extent possible (see data reliability issue section for more information).
Corporate Income	8,136,986	1,510,840	Approximately \$3.3 million of the amount abated in 2015 resulted from the processing of backlogged returns in VTax (see explanation that follows Table 1).
Meals and Rooms	1,443,791	1,784,703	
Sales and Use	1,966,563	4,113,681	According to the data extract, the VTax system abated approximately \$1.1 million of tax liabilities in 2016 due to statutory limitations on the collection of SUT owed. <sup>c</sup> Seven abatements <sup>d</sup> reviewed by SAO as part of the sample, were due to settlements and account for approximately \$1.2 million of the 2016 SUT abatements.
<b>TOTAL</b>	<b><u>\$37,554,678</u></b>	<b><u>\$10,716,918</u></b>	

a About \$13.9 million resulted from the processing of backlogged returns in VTax (see explanation below).

b Partnerships, S-corporations, and limited liability companies are statutorily required to make estimated income tax payments on behalf of nonresident shareholders, members, or partners. 32 V.S.A. 5914(c) and 32 V.S.A. 5920(c).

c Generally, VDT may pursue collection of SUT tax liabilities for six years from the date SUT is due (32 V.S.A. §9812). The VTax system is programmed to automatically write-off tax liabilities when the statute of limitations on collections has expired for collecting debt.

d These abatements were included in the sample items that were reviewed by SAO.

Unlike the previous system, VTax is configured to check whether businesses with nonresident shareholders, members or partners (the owners) made required NRW payments.<sup>11</sup> According to VDT, businesses contact the department after receiving a nonresident withholding assessment and provide information showing the payments were made directly by the owners. If the entity provides sufficient information showing the payments were made by the owners, VDT will abate the assessment.

According to VDT officials, at the time of the transition to VTax, there was a backlog of 32,000 unprocessed corporate and business income tax returns from the previous tax system. The previous tax system was not able to process corporate returns, which were largely paper filings, and had difficulty with business income tax returns that involved nonresidential withholding. Once the backlogged returns were processed in the VTax system, it identified tax amounts due. For many, VDT

<sup>11</sup> Business entities with nonresident owners are statutorily required to make estimated income tax payments on behalf of their shareholders, members, or partners for income attributable to Vermont. These estimated payments are then reported on the tax return of the individual shareholder, member or partner.

had not timely assessed tax liabilities and could not pursue collection because of time limitations in statute. It's not known how much of these tax liabilities would have been collected had VDT timely processed these returns and identified the tax liabilities prior to the statutory deadline.

SAO found problems with the VTax data including, 1) the classification of transactions as abatement or write-off was not meaningful, 2) transactions recorded as abatements that were not abatements, and 3) understatement of abatements by approximately \$1.7million. In addition, VTax is configured to check whether businesses paid their statutorily required NRW estimated payments, but VDT personnel explained that the system was not configured to determine whether deficiencies in nonresident withholdings by businesses were offset by payments made via nonresidents' income tax filings. SAO believes the NRW adjustments are the result of an operational issue and represent correction of the generation of unnecessary tax assessments rather than an abatement. Therefore, abatements of BIT were overstated in 2015 and 2016 because of these transactions. It's possible to identify some NRW transactions using specific codes in a VTax field, but not all, so it's not possible to identify the total amount that BIT abatements were overstated.

VDT issued a revised policy for tax abatements, adding write-offs and definitions for abatement and write-off in December 2016 and provided training to VDT staff. These efforts could resolve the department's failure to distinguish between abatements and write-offs prior to the revision. In addition, as of February 2018, VTax has been configured to delay billing when a business entity has not made the statutorily-required estimated NRW payments, but all nonresident individual owners have filed a personal income tax return or requested extension of filing. During the period the bill is delayed, the department reviews the account to determine if payments were made via the nonresidents' personal income tax returns and whether the billing may be reduced.

Other issues remain unaddressed. For example, SAO found that 16 of 70 abatements selected for testing from the 2015 and 2016 data extracts were neither an abatement nor a write-off. VDT agreed that the 16 transactions were not traditional abatements or write-offs but indicated that the department had determined for a variety of reasons that certain adjustments of tax liabilities would be recorded as abatements. However, VDT did not develop a uniform method of recording these transactions in VTax, so there was no way to distinguish them from transactions that represent actual abatements. While the department has reasons for using the adjustment process for fixing these types of issues, without some way to accurately identify these transactions, the amount of abatements and write-offs will continue to be overstated.

## Other Matters

SAO was also informed by VDT staff about three other transactions that were not abatements, but the VDT staff believed were not handled appropriately by the department. These are discussed in the section Other Matters.

## Recommendations

We made a variety of recommendations to the Commissioner of the Vermont Department of Taxes and have one matter for the Legislature to consider. Recommendations to the Commissioner include the following:

- Implement written guidance that addresses how to document the reason for abatements.
- Remedy the discrepancy between the permissions established in VTax and VDT's SOP for abatements.

## Background

The Commissioner of VDT is responsible for the administration and enforcement of all taxes within his or her jurisdiction.<sup>12</sup> When a taxpayer fails to pay a tax owed, the Commissioner may assess interest.<sup>13</sup> The Commissioner may also assess penalties for circumstances such as failure to file a tax return that is required by Title 32 of Vermont Statutes Annotated or failure to pay a tax owed.<sup>14</sup>

VDT administers many types of taxes, including business taxes. These include the following:

**Business Entity Income Tax** [32 V.S.A. § 5920, 32 V.S.A. § 5914] – Pass-through entities, including S-Corporations, Partnerships, and Limited Liabilities Companies (LLCs) that elect to be taxed as Partnerships or S-Corps, are subject to Vermont’s business income/business entity tax laws and provisions. The income of S-Corporations, Partnerships and LLCs attributable to Vermont passes through to the shareholders, partners, or members, who are required to file a Vermont income tax return, and the income is taxed at the individual or corporate income tax rate.

**Nonresident Withholding** [32 V.S.A. § 5914 (c), 32 V.S.A. § 5920 (c)]– Business entities with nonresident owners must make estimated income tax payments on behalf of their shareholders, members, or partners for income attributable to Vermont. Entities cannot delegate the requirement to make estimated payments to the nonresident. These estimated payments are then reported on the tax return of the individual shareholder, member or partner.

**Corporate Income Tax (CIT)** [32 V.S.A. § 5832]– C-Corporations, LLCs that elect to be taxed as corporations, and certain nonprofit organizations are subject to Vermont’s corporate income tax laws and provisions. The corporate income tax is a net income tax based on income allocated to Vermont. A minimum tax applies to all active corporations and LLCs electing to be taxed as corporations.

**Sales and Use Tax (SUT)** [32 V.S.A. § 9812]– Businesses are responsible for collecting sales tax from their customers and then filing and remitting the tax to the state. Vermont’s sales tax of 6 percent<sup>15</sup> is imposed on the retail sales of tangible personal property unless exempted by law. Use tax is paid 1) by

<sup>12</sup> 32 V.S.A. §3101(10)

<sup>13</sup> 32 V.S.A. §3202(a)

<sup>14</sup> 32 V.S.A. §3202(b)

<sup>15</sup> A municipality may vote to levy any combination of one percent local option taxes in addition to state business taxes – sales, meals, alcoholic beverage, and rooms taxes. The local option tax is remitted to VDT.



the purchaser of an item when the purchase is made from a vendor that is not registered by the state of Vermont to collect sales tax, 2) when a business uses property that it normally manufactures for sale, or 3) when property is used in the operation of a business or is for personal use and it was originally purchased for resale with an exemption certificate. Sales tax and use tax work together to create the same tax result whether a vendor collects sales tax or not. Therefore, use tax has the same rate of 6 percent, rules, and exemptions as sales tax.

**Meals and Rooms Tax (MRT)** [32 V.S.A. § 9280] - Any private person, entity, institution, or organization selling meals, serving alcohol, or renting rooms to the public must collect the Vermont Meals and Rooms Tax from their customers on their gross receipts and remit the tax to the Vermont Department of Taxes.

### VDT Authority to Reduce Tax Liabilities

Various statutes and the Code of Vermont Rules address VDT's authority to reduce tax liabilities.

The Commissioner may, after making a record of the reasons why, waive, reduce, or compromise any of the taxes, penalties, interest, or fees within his or her jurisdiction. [32 V.S.A. § 3201 (a)(5)]

The Commissioner may grant relief in the case of an extraordinary relief recommendation from the Taxpayer Advocate. [32 V.S.A. § 3206 (a)-(e)]

The Commissioner may compromise a tax liability upon grounds of doubt as to liability or doubt as to collectability or both. [32 V.S.A. § 5887 (c)]

The Commissioner may delegate to any officer or employee in the department the powers necessary to carry out tax provisions within the Commissioner's jurisdiction. [32 V.S.A. § 3201 (a)(2)]

Under the Department of Taxes "Organization and Rules of Procedure," it states that in evaluating any settlement proposal, the department "shall consider evidence and arguments that support the taxpayer's position, hazards of litigation, factors affecting collectability of an assessment, equity among taxpayers and the requirements of law." [CVR 10-060-028 Organization and Rules of Procedure, Rule 4. Appeals (b)]

### VDT Policies and Programs for Abating Tax Liabilities

*Standard Operating Procedure 2001-02 "Tax Liability Abatements"*

In effect from January 1, 2002 to December 12, 2016, the purpose of the procedure was "to establish a standard operating procedure for abating tax

liabilities that applies standards and criteria consistently throughout the department to provide fair and equitable treatment for taxpayers.”

The procedure included the following permissions and limitations over abating tax liabilities:

- It is the policy of the department to remove penalty for failure to file upon showing by the taxpayer that the failure was due to reasonable cause.
- Circumstances meriting waiver are causes that arise despite the ordinary care and prudence of the taxpayer, at the taxpayer’s burden of proof.
- Grounds for waiving interest or base tax are limited to extraordinary circumstances and may be waived only by the Commissioner, Deputy Commissioner, General Counsel, and Directors.
- Other department employees may waive penalties within bounds set by their supervisor.
- Commissioner may authorize any employee to waive interest charges in specific circumstances.

The types of circumstances that qualify as reasonable cause include mail delivery problems, death or serious illness, unavoidable absence, etc. Additional procedures relate to circumstances for waiving late filing and late payment penalties. One section outlines considerations for abatements in audit situations, and the final section discusses offer in compromise.

Offer in compromise is a settlement of a tax liability for less than full payment and can be used in some instances to collect more tax revenue than through any other means available to the department. The procedures state that offer in compromise is addressed in a separate standard operating procedure; a guide to the Offer in Compromise Program was issued November 2017.<sup>16</sup>

*Standard Operating Procedure 2016-02 “Tax Liability Abatements and Write-Offs”*

A revised standard operating procedure, “Tax Liability Abatements and Write-Offs” was issued on December 13, 2016. The purpose was modified to add that the SOP now defines the different treatment between an abatement and write-off and the importance of making the proper distinction between the two options. Other revisions include the following:

- Definitions for “abatement” and “write-off.”
- A statement of the commissioner’s statutory authority to waive, reduce or compromise taxes, interest, penalties, and other fees.

<sup>16</sup> The offer in compromise policy, issued November 2017, was not applicable to the period subject to audit, 2015-2016.

- A listing of the reason codes available in VTax to classify each abatement or write-off.
- Approval threshold chart showing at what dollar threshold staff would need to seek approval from Supervisors or Directors to authorize an abatement or write-off. For example, staff can abate up to \$5,000 in corporate income tax penalty but must seek approval from a supervisor for abatements over \$5,000.

### Voluntary Disclosure Programs

The department offers programs to encourage taxpayers to come forward in return for reduced tax assessments. The taxpayer must not have been contacted by the department with an audit<sup>17</sup> inquiry prior to making the request for the program.

If a legitimate claim is made for voluntary disclosure of sales and use tax, corporate, or business income tax, the department will limit prior period exposure to three years or to the date the exposure was established, whichever is shorter. The department may agree to waive all penalties if tax and interest are paid when assessed. In the case of sales tax, if the taxpayer has been collecting sales taxes from customers and not paying it, the prior period will extend to include all liabilities of this type.

For other tax types, such as meals and rooms, applicants must contact the department directly for information on time exposure and penalties.

In September 2016, the department announced an agreement with Airbnb to collect meals and rooms tax on payments for lodging offered by its hosts commencing October 1, 2016. Hosts on Airbnb would not be responsible for any back taxes they had failed to collect. In addition, VDT offered a voluntary come-forward program for hosts on other platforms. Between September 15, 2016 and November 1, 2016, hosts on other platforms that came forward to voluntarily register with VDT to collect and remit meals and rooms tax going forward would not be liable for any back meals and rooms taxes owed.

### Tax Information Technology Systems

In 2001, VDT finalized implementation of the Advantage Revenue system for processing trust taxes, including sales and use tax and meals and rooms tax. In 2010, the department began using the Enterprise Tax Management (ETM) system to process corporate tax and business income tax. The department had problems with the ETM system, such as high processing times and unfriendly user experience, and the department considered making a

<sup>17</sup> VDT defines an audit as an examination of a taxpayer's books and records to determine whether taxes are being correctly reported.

technical upgrade to ETM. VDT solicited input from several sources, but in the end decided to implement an integrated tax solution to consolidate all Vermont taxes into one system. In 2013, the department decided to implement a commercial off-the-shelf system<sup>18</sup> that they named VTax.

VTax was scheduled to be rolled out in four phases over four years. In 2014 (phase 1), the department started using VTax for corporate and business income taxes. In 2015 (phase 2), the department started using VTax for sales and use and meals and rooms taxes. In December 2016 (phase 3), personal income tax was added to VTax.

## Objective 1: Majority of Abatement Reasons Consistent with Statute and VDT Policy, but Documentation Methods Could be Improved and Some Lacked Approval

The VDT commissioner has broad statutory authority to waive, reduce, or compromise taxes, penalties, interest, or other charges or fees within VDT's jurisdiction and must document the reason for adjusting these tax liabilities.<sup>19</sup> Statute, rules, and the department's abatement policy address the circumstances that warrant waiving, reducing, or compromising tax liabilities.

For 36 of 59<sup>20</sup> abatements and write-offs reviewed (61 percent), hereafter referred to as abatements, SAO concluded that VDT's documented reason was consistent with 1) the department's policies for abating tax liabilities, 2) VDT's interpretation of rules for settlements, or 3) was based on a departmental appeal ruling, or 4) the department had cited statutory limitations on collection of tax liabilities<sup>21</sup> or bankruptcy. However, VDT's method of documenting reasons for these abatements was inconsistent, and

<sup>18</sup> Fast Enterprises, LLC was selected to implement its commercial off-the-shelf GenTax® software application.

<sup>19</sup> 32 V.S.A. §3201(a)(5)

<sup>20</sup> SAO selected a non-statistical sample of 70 abatements. Sixteen were determined not to be traditional abatements and were excluded from further analysis. Six additional abatements were brought to the attention of SAO by current and former VDT staff who believed the decision to abate tax liabilities in these instances was not justified. One of these had already been selected as part of the non-statistical sample.

<sup>21</sup> 32 V.S.A. §5892(a), 32 V.S.A. §9812(a), 32 V.S.A. §9280(c).

reason codes<sup>22</sup> used in VTax did not always reflect information in a notes field in VTax<sup>23</sup> or in supporting documentation.

For 16 other abatements (27 percent), VDT failed to document a reason that was consistent with department policies, regulations, or statute. In the remaining seven abatements (12 percent), VDT documented a reason that was consistent with the department's policies, rules, or statute for only a portion of what was abated.

According to VTax records, the department processes thousands of abatements annually. We believe that an inconsistent approach to documenting reasons for abatements or failing to document the reason for abatements makes it difficult for the department to determine whether its policies and rules have been applied consistently to provide fair and equitable treatment for taxpayers, the stated purpose of VDT's abatement SOP.

Some of the abatements were not approved at the requisite staff level per the department's abatement SOP. Some staff had the ability to approve abatements because the permissions for approving abatements established in VTax allowed them to do so even though the SOP did not. Approval requirements are in place to ensure that department officials agree with conclusions of personnel and verify that transactions have been recorded accurately and with justified reasons.

## Reasons Consistent for Most Abatements Reviewed; Documentation Methods Not Systematic

For 61 percent of abatements (36 of 59) reviewed by SAO, VDT had documented a rationale that was consistent with 1) VDT policy, 2) the department's interpretation of the rule for evaluating settlements, or 3) the rationale was based on a departmental appeal ruling, or we found the department had cited statutory limitations on collection of tax liabilities<sup>24</sup> or bankruptcy. See Table 2 for detail on liability type, tax type, amount abated, and examples of reasons for the 36 abatements.

<sup>22</sup> See Appendix III for the list of reason codes.

<sup>23</sup> An adjustment notes field in VTax allows VDT to record text.

<sup>24</sup> 32 V.S.A. §5892(a), 32 V.S.A. §9812(a), 32 V.S.A. §9280(c).

**Table 2: Characteristics of Thirty-six Abatements Documented Consistent with Statute and VDT Policy**

Liability Type	Tax Type	Number of Abatements	Amount	Reason Examples
Penalty	BIT, MRT, SUT	12	\$458,909	Reasonable cause due to ACH payment issues; first error for business taxes; first time filer; voluntary disclosure program
Penalty and Interest or Penalty and Tax	BIT (NRW), MRT, SUT	11	\$163,650	Reasonable cause due to ACH payment issues; bankruptcy
Penalty, Interest, and Tax <sup>a</sup>	CIT, MRT, SUT	9	\$2,290,807	Statute of limitations on collections; risk of litigation; additional information provided by taxpayer; collectability; overturned on appeal
Unknown <sup>b</sup>	MRT, SUT	4	\$192,642	Risk of litigation and statute of limitations on collections
<b>TOTALS</b>		<b>36</b>	<b>\$3,106,009</b>	

a One of these abatements was just tax and interest.

b These transactions were processed in the previous tax system and detail was not available for which category of tax liability (penalty, tax, or interest) was abated.

Although we concluded that VDT had documented a reason that was consistent with statutory requirements, VDT policy, or the department’s interpretation of the rule for settlements for these 36 abatements, we found problems with VDT’s documentation.

VDT’s method of documenting reasons was haphazard. Some reasons were documented via reason codes and the adjustment notes field in the VTax data. Others had reason codes and source documents. The source documents varied but included one or more of the following: internal VDT emails, Commissioner’s ruling in an appeal, correspondence with the taxpayer, or policy or legal memos.

In addition, we found that reason codes for 20 of the 36 abatements were inconsistent with information contained in the adjustment notes field, did not reflect the actual reason for abatement that was contained within various documents, or were not specific enough to conclude that they reflected the reason for abatement (e.g., “administrative decision”). As a result, reason codes recorded in VTax have limited utility. A VDT manager acknowledged that selection of reason codes was arbitrary and that it is a training issue.

The department processed thousands of abatements in 2015 and 2016. The Department of Finance and Management's (DFM) internal control guide<sup>25</sup> indicates that documentation should have a clear purpose and be in a usable format that will add to the efficiency and effectiveness of the department. The lack of a systematic method of documenting the reasons and the limited utility of the reason codes could hinder management's ability to efficiently and effectively monitor the adequacy of the reasons for abatements.

## For Thirty-Nine Percent of Abatements, Reasons Not Documented, Not Consistent with VDT Practices, or Only Partially Documented

For 16 abatements reviewed by SAO (27 percent of 59 reviewed), VDT did not document a reason for abating tax liabilities, cited a reason that was not applicable to the taxpayer's circumstances, or documented a rationale that was not consistent with VDT policy or rules. The total amount of these abatements is approximately \$578,000.

- For example, a VDT examiner cited "first time taxpayer late payment" as the reason for adjusting late filing and late payment penalties for one abatement, but the examiner's notes in VTax indicate that the taxpayer failed to file and pay taxes for six years.
- In another example, the former commissioner abated penalty, interest, and tax. She cited "history of good faith efforts to comply with tax law" and a change to the tax law as reasons even though the official letter ruling on the taxpayer's appeal concluded that the tax was owed. The change to the tax law cited by the former commissioner occurred after the period for which tax was owed. Neither of the circumstances cited by the former commissioner are circumstances warranting abatement per VDT policies or rules.

According to the former commissioner, VDT's practice was to abate tax related to in-process disputes if the legislature changed the law to reflect the taxpayer's position. She explained that this occurred during the appeal process for this specific taxpayer. This practice is not reflected in the department's policies, but the commissioner has broad statutory authority to abate taxpayers' assessments, and she documented the reasons as required by statute. However, to the extent similarly-situated taxpayers paid tax in accordance with the law prior to the change, the abatement of the tax for this taxpayer might be viewed as inequitable.

<sup>25</sup> *Internal Control Standards: A Guide for Managers*, Department of Finance and Management.

For seven abatements (12 percent of 59 reviewed), totaling approximately \$4 million, VDT documented a reason for a portion of the abatement that was consistent with statutory requirements, policies, or VDT's interpretation of rules for settlements. The portion abated for which there was no documented reason, or the reason was not consistent with statute, rule, or policy was approximately \$1 million.

- In two cases where penalty and interest were abated, the reasons cited were the department's voluntary disclosure program and first time use tax audit. According to VDT's policies, these are reasons to abate penalty, but not interest, and no additional reason was provided for why interest was abated. The amount of interest abated was negligible, but the purpose of the policies is to ensure fair and equitable treatment for taxpayers and failure to follow policies could be detrimental to this purpose.
- In five cases, the department agreed to settle for less than the total tax liability. VDT documented that there was risk in pursuing litigation or the taxpayer produced additional evidence. These are two of the five factors required to be considered by VDT when evaluating a settlement, and these reasons explained a portion of the reduction of the tax liabilities. However, the remainder of the reduction was unexplained, or the documented reason was not based on statute, policy, or rule. For example, for one abatement the previous commissioner determined that VDT should abate all the penalty and half of the interest, totaling more than \$380,000, for issues that were not contested by the taxpayer, because of VDT's culpability for the delay in resolving the case and a desire to get an old case settled. It does not seem unreasonable to consider VDT culpability, but it isn't currently addressed in VDT's policy on abatement and is not explicitly stated in the factors to be considered in a settlement. In addition, expediency is not addressed in the rules or the policy on abatements.

The former commissioner indicated that she was not certain the abatement could be separated into two components and that the risk of litigation related to the entire abatement. However, a VDT auditor had prepared an analysis that showed the tax assessment consisted of contested and uncontested issues. We concluded that the risk of litigation cited by the department clearly related to the contested issues, but do not agree that it extended to the portion categorized as uncontested in VDT's records. The commissioner has broad statutory authority to abate and she documented the reasons, even if it appears to depart from VDT's rules and policy. However, there is risk that departures from policies and rules will lead to inconsistent treatment of taxpayers and the reasons for abatement will appear arbitrary.



Nine of the 23 abatements, for which all or a portion of the amount abated did not have a documented reason consistent with statute, rules, or policies, were the result of settlements negotiated with taxpayers. According to VDT Rules of Procedure CVR 10-060-028, Rule 4(b), when evaluating a settlement proposal, VDT is required to consider a series of factors, including evidence and arguments that support the taxpayer's position, hazards of litigation, factors affecting collectability, equity among taxpayers, and requirements of law.

Department officials told us that the five factors are considered and discussed when evaluating settlements, but there was no documentation of how each of the factors were applied. According to the VDT General Counsel, there is no requirement that the evaluation of the factors be documented, only a reason for an abatement must be documented per statute.

In a 2012 VDT study on taxpayer appeals,<sup>26</sup> the department reported that broad concerns must be taken into consideration in deciding whether to settle a case. For instance, the department must consider hazards of litigation, but it must also consider the equities of how settling the case might affect all the other taxpayers who have complied with the law and how settling might affect the department's ability to enforce that particular law against other taxpayers in the future. In addition, the department cannot settle to avoid the time and expense of litigation.

The rule does not specify that the five-factor evaluation be documented. However, DFM's internal control guidance for managers indicates that documentation preserves evidence to substantiate a decision, event, transaction, or system, and documentation should be complete, accurate, and recorded timely. Without documentation of the evaluation, the department lacks a record that demonstrates how VDT balanced the risk of litigation, equity among taxpayers, and ability to enforce tax law in the future. Further, the department does not have a clear record to demonstrate compliance with the rule that requires the five-factor evaluation.

## Cause for Documentation Issues and Failure to Document a Reason for Abatement

The lack of a systematic approach, limited utility of reason codes, and the failure to adequately document a reason may be because the department's SOP 2001-02, "Tax Liability Abatements," applicable in 2015 and most of 2016, did not address the requirement for VDT to document a reason. A VTax

<sup>26</sup> *A Study of Taxpayer Outreach and Information Systems: Part 2. Taxpayer Appeals*, January 17, 2012, by the Vermont Department of Taxes

desk guide, revised September 23, 2016, explained the procedures for recording an abatement in the VTax system, including the requirement to select a reason code, but it did not address what should be documented in the adjustment notes field. Neither document addressed what external documents, if any, should be retained to substantiate the reason code selected or the information included in the adjustment notes field.

The department released an updated abatement policy December 13, 2016, SOP, 2016-02, "Tax Liability Abatements and Write-Offs," which addressed the requirement to document the reason for abatement and incorporated a list of reason codes. However, the policy still does not include guidance about how to document the reason for abatement or definitions for the reason codes. Department personnel explained that the codes were intended to be self-explanatory, but some signify processes, not reasons for abatement, such as administrative decision, offer and compromise, and settlement.

DFM's internal control guide specifies that documentation of policies and procedures is critical to the daily operations of a department and provides specific direction to and helps form the basis for decisions made by employees. Without this understanding by employees, conflict can occur, poor decisions can be made, and serious harm can be done to the department's reputation.

## Approval for Abatements Not Always Obtained at Requisite Level

We also found that 17 of 59 abatements<sup>27</sup> were not authorized at the requisite staff level, per the SOP that was in effect in 2015 and most of 2016. This is likely due to the discrepancy that existed between approval requirements in SOP 2002-01 and the permissions for approving transactions that were established in VTax. The VTax permissions are based on dollar levels while the SOP required certain staff levels to authorize abatements of interest and tax.

The SOP stated: "Base tax and interest charges, in part or in total, may be waived only by the Commissioner, the Deputy Commissioner, General Counsel, and the Directors of Compliance, Taxpayer Services and Property Valuation and Review." However, we found abatements of tax and interest were approved by staff without these job titles who had had been assigned "unlimited" authority in VTax, meaning they had the ability to approve any amount of abatement of tax, interest, and penalty.

<sup>27</sup> Thirteen of the 59 abatements were processed in the previous tax system and there was no evidence in the data extract or in other information provided by VDT regarding who had approved these abatements.

Per DFM's internal control guide, authorization is the activity designed to ensure events or transactions are initiated and executed by those designated by management. Approval requirements are in place to ensure that department officials agree with conclusions of personnel and verify that transactions have been recorded accurately and with justified reasons. Management should ensure that the conditions and terms of authorizations are clearly documented and communicated, and that significant transactions are approved by persons management has designated with the authority to do so. To the extent that there continues to be inconsistency between the approval levels established in SOP 2016-02 and permissions established in VTax, the department won't have assurance that transactions are initiated and executed at the requisite staff level.

The revised SOP, 2016-02, effective December 13, 2016, lists specific approval limits by job title and for tax type/tax liability. For example, staff are authorized to abate or write-off corporate penalties up to \$5,000, after which a supervisor must approve the transaction; supervisors may abate or write-off corporate penalties up to \$25,000, after which an assistant director or director must approve the transaction. Staff can abate or write-off tax and interest for corporate liabilities up to \$2,500, after which an assistant director or director must approve. The VTax permissions remain the same, based on dollar amounts only. According to VDT, the revised SOP was being finalized at the same time as Phase 3 of implementing VTax was occurring. The department did not want to reallocate resources to adjust the security thresholds in VTax to match the new SOP, as the work is resource-intensive. Per VDT, the department is evaluating what action to take.

To determine if abatements were being approved according to limits in the revised SOP, we analyzed data in an extract of abatements made between January 1, 2017 and March 31, 2017. Of the 2,037 abatements in the extract, 127 (6 percent) were approved for a higher amount than the SOP authorized for the staff making the abatement. This is a considerable improvement over the results from abatements under the previous SOP, but conflicts between the SOP and VTax permissions remain and there is still risk that unauthorized abatements could occur.

## Objective 2: Significant Abatements Per VTax, but Data Could Not be Used to Conclude on Total Amount of Tax Liabilities Abated

According to data extracts from VDT's VTax system, abatements of tax liabilities for business income, corporate income, meals and rooms, and sales

and use taxes were significant in calendar years 2015 and 2016 (see Table 3). However, several limitations in the VTax data led us to conclude the data in these extracts was not reliable for purposes of our audit objective. For example, adjustment types in VTax included abatements and write-offs and were used by VDT staff to categorize the reduction of tax liabilities. However, the use of these adjustment types was not meaningful in 2015 and 2016 because VDT had not defined them in the abatement policy effective during 2015 and most of 2016. Further, VDT personnel explained that the department made no distinction between the two terms prior to December 2016.

The VTax data is the only source of information about abatements, so we present the data in total by tax type and year in Table 3. Because of reliability concerns, the information in this table should not be used to draw conclusions about the total amount of tax liability abatements by VDT for the tax types in Table 3.

**Table 3: Abatements by Tax Type for Calendar Years 2015 and 2016, per VTax Data**

<b>Tax Type</b>	<b>2015</b>	<b>2016</b>	<b>Comments</b>
Business Income	\$26,007,338	\$3,307,694	At least \$24.2 million <sup>a</sup> and \$2.5 million of the abatement of business income tax (BIT) in 2015 and 2016, respectively, represented reduction of tax liabilities related to NRW. <sup>b</sup> SAO utilized data points in the VTax data extracts to identify which BIT abatements were related to NRW, to the extent possible (see data reliability issue section for more information).
Corporate Income	8,136,986	1,510,840	Approximately \$3.3 million of the amount abated in 2015 resulted from the processing of backlogged returns in VTax (see explanation that follows Table 3).
Meals and Rooms	1,443,791	1,784,703	
Sales and Use	1,966,563	4,113,681	According to the data extract, the VTax system abated approximately \$1.1 million of tax liabilities in 2016 due to statutory limitations on the collection of SUT owed. <sup>c</sup> Seven abatements <sup>d</sup> reviewed by SAO as part of the sample, were due to settlements and account for approximately \$1.2 million of the 2016 SUT abatements.
<b>TOTAL</b>	<b><u>\$37,554,678</u></b>	<b><u>\$10,716,918</u></b>	

a About \$13.9 million resulted from the processing of backlogged returns in VTax (see explanation below).

b Partnerships, S-corporations, and limited liability companies are statutorily-required to make estimated income tax payments on behalf of nonresident shareholders, members, or partners. 32 V.S.A. 5914(c) and 32 V.S.A. 5920(c).

c Generally, VDT may pursue collection of SUT tax liabilities for six years from the date SUT is due (32 V.S.A. §9812(a)). The VTax system is programmed to automatically write-off tax liabilities when the statute of limitations on collections has expired for collecting debt.

d These abatements were included in the sample items that were reviewed by SAO.

Based on information in the VTax data extracts and information provided by VDT personnel, NRW and backlogged returns significantly impacted abatements in 2015 and NRW impacted 2016 as well:

- *Nonresidential withholding (NRW)*: The department's previous system was not programmed to bill for NRW, but VTax is configured to check whether businesses paid their statutorily required nonresident withholding estimated payments. If VTax finds that a business with nonresident owners has not paid NRW, the system estimates a tax liability and generates a bill to the business. According to VDT, payments are often made directly by the owners and not from the business entity, as required by statute.

Typically, businesses contact VDT after receiving a nonresident withholding assessment and provide information showing the

payments were made directly by the owners. If the entity can provide sufficient support, VDT abates the assessment.

- *Backlog of unprocessed returns from the previous tax system:* According to VDT officials, at the time of the transition to VTax, there were approximately 32,000 unprocessed corporate and business income tax returns, an issue that originated in 2009. The previous tax system was not able to process corporate returns, which were largely paper filings, and had difficulty with business income tax returns that involved nonresidential withholding. Once the VTax system processed the backlogged returns, it identified outstanding tax amounts due. For many returns, VDT had not timely assessed tax liabilities and could not pursue collection. Per statute, VDT may assess tax liabilities within three years of the later of the return due date or filing date, with some limited circumstances allowing for extension beyond three years.<sup>28</sup> It's not known how much of these tax liabilities would have been collected had VDT timely processed these returns and identified the tax liabilities prior to the statutory deadline.

## Data Reliability Issues Require Attention

Several limitations in the VTax data extracts led us to conclude the data in these extracts was not reliable for purposes of our audit objective. VDT has taken actions that address some of these concerns, but additional efforts are needed.

*Categorization of the reduction of tax liabilities into abatements and write-offs within the data extracts was not meaningful in 2015 and 2016.* The VTax system contains a data field for differentiating between abatements and write-offs,<sup>29</sup> but the department's SOP 2002-01, Tax Liability Abatements, in effect for all of 2015 through December 12, 2016, refers solely to abating tax liabilities. According to VDT personnel, prior to December 13, 2016, the effective date of SOP 2016-02, the department did not make a distinction between abatements and write-offs. Definitions of the two terms were included in the revised SOP, and the email distributing the revised SOP in December 2016 highlighted the distinction between abatements and write-offs. The department also provided training on the revised SOP in January and April 2017.

<sup>28</sup> VDT can extend this to six years when more than 20 percent of income has been excluded from a filed return and if there was fraud. 32 V.S.A. §5882(b)(5), 32 V.S.A. §9815(b), 32 V.S.A. §9273(b)

<sup>29</sup> "Small balance adjustments" and "adjustment agreement" are two other categories of adjustments available.

*The VTax data extracts include transactions that VDT agreed aren't traditional abatements or write-offs and SAO believes the result is a misstatement of total abatements. SAO found that 16 of 70 transactions selected for testing from the 2015 and 2016 data extracts, totaling approximately \$1.4 million, were neither an abatement nor a write-off, even though the information in the data extracts indicated they were one or the other.*

VDT personnel explained that the transactions identified by SAO were the result of three different circumstances in which the department had determined to use the adjustment module in VTax to reduce tax liabilities, even though the adjustments were not an abatement or a write-off. For example, during system design for VTax, the department decided to keep penalty and interest static for business tax liabilities converted from the previous system, rather than having VTax recalculate penalty and interest, and that upon conversion any needed corrections would be processed by VDT staff in the adjustment module.

Staff used seven reason codes to categorize the three different circumstances described by the department. Specifically, ten of the sixteen transactions related to the system design decision for converting business tax liabilities from the previous system, and VDT staff selected six different reason codes for this type of adjustment, including "administrative decision" and "reasonable cause." While the department has reasons for using the VTax adjustment process for fixing these types of issues, it did not implement a reason code that would allow the transactions to be easily identified and did not provide written guidance to staff about how to record these adjustments. Without a consistent way to record these transactions, VDT lacks a mechanism to identify them. Because of this, the department does not know the dollar amount that abatements are overstated by these transactions, which hinders the department's ability to review its abatement activity.

*VTax data can be used to identify many BIT abatements related to NRW, but not all. SAO believes most of the NRW-related abatements are not traditional abatements and abatements are overstated because of this. The data extracts included thousands of abatements of BIT related to NRW. According to VDT, specific codes in a VTax field may be used to identify some abatements of BIT related to NRW, but not all, so the total amount of overstatement cannot be identified for 2015 and 2016.*

VTax was configured to check whether businesses paid their statutorily required nonresident withholding estimated payments, but VDT personnel explained that the system was not configured to determine whether deficiencies in nonresident withholdings by businesses were offset by payments made via nonresidents' income tax filings. According to a VDT manager, this resulted in a significant amount of manual verification performed by staff to determine if abatements were warranted.

SAO believes that these adjustments are the result of an operational issue and are a correction of the generation of unnecessary tax assessments rather than an abatement. If VTax had been configured with the functionality to verify that all nonresident owners filed a return prior to generating the assessment, these bills may not have occurred.

A business decision was made not to prioritize this functionality during implementation of VTax for BIT and CIT in 2014 to ensure timelines were met. In February 2018, VTax was configured to delay billing when a business entity has not made the statutorily-required estimated NRW payments, but all nonresident individual owners have filed a personal income tax return or requested extension of filing. During the period the bill is delayed, the department reviews the account to determine if payments were made via the nonresidents' personal income tax returns and whether the billing may be reduced. The department believed that most requests for abatements related to personal income taxes and focused its effort on individual nonresident owners. According to VDT, VTax has not been programmed to delay billing of NRW when a corporation is one of the nonresident owners because complexities associated with corporate income tax filings would have slowed down implementing the change for individual nonresident owners. Because the system is not configured to delay billing for all nonresident owners to allow for a manual review before issuing a bill, there is potential for unnecessary bills to be issued and abatements to be overstated.

*Abatements were understated by \$1.7 million during the audit period because an abatement was not recorded timely and another transaction was not recorded as an abatement but should have been. One abatement reviewed by SAO was not recorded in VTax in a timely manner and was not included in the data extracts provided by VDT, although it should have been. The transaction was the result of a settlement that was not recorded in VTax until ten months after the settlement date. According to VDT, the delay was the result of the complexity of recording the adjustment in the system.*



Another abatement resulted from an appeal where the taxpayer was found to owe tax, but the former commissioner determined to abate a portion. The adjustment was processed in the previous tax system as a change to the audit which posted less tax. However, the transaction was an abatement and should have been recorded as such. It's not clear why the adjustment was handled this way, but the former commissioner believed there may have been confusion about how to reflect transactions appropriately in the system.

DFM's guide on internal control standards indicates that all documentation should be complete, accurate, and recorded timely. The department's revised SOP, "Tax Liability Abatements and Write-Offs," includes an abatement definition which may help VDT staff recognize when a transaction should be recorded as an abatement, but it does not address the importance of timely recording abatements.

*The amount abated in VTax for the components of tax liabilities (tax, interest, and penalty) for two sample items did not equal the amount VDT agreed to abate for tax, interest, and penalty per supporting documents.* In one example, according to correspondence with the taxpayer and information in the VTax system, VDT agreed to abate approximately \$403,000 of tax and \$324,000 of associated interest and penalties, but the entire amount, approximately \$727,000, was recorded in the VTax system as an abatement of tax. VDT explained that this could occur as result of the VTax convention that applies taxpayer late payments first to interest and penalty, and then tax. Often tax is the unpaid balance because the other elements take priority for payment offset. The VTax user would have to specifically force the abatement or write-off onto the "paid" transactions and it may not have been a familiar process in these cases. If the VTax user does not take this action, the reductions to the various components of tax liabilities in VTax will not match what is in supporting documents and tax, interest, and penalty abated will be misstated in VTax. The VTax desk guide on adjustments explains that payments received prior to the abatement will be applied to interest and penalty first and then to tax. It includes instructions for how to abate interest and penalty that have been previously paid off, however the procedures do not explicitly state that this must be done.

VDT's failure to differentiate between abatements and write-offs in 2015 and most of 2016, its decisions to delay configuring VTax to address NRW billings and to record transactions as abatements that are not traditional abatements, and the other issues SAO identified negatively impacted the usefulness of abatement data in the VTax.

extracts. According to DFM's internal control guide, managers must be able to obtain reliable information to determine their risks and they need operating information to determine whether a department is achieving its compliance requirements under various statutes and regulations. VDT has addressed some of the issues that led us to conclude the VTax data was not reliable for purposes of summarizing total tax abatements in 2015 and 2016. The department defined abatements and write-offs in a revised SOP and highlighted the importance of distinguishing between the two transactions. The department also partially addressed unnecessary NRW billings. Given that some issues have not been addressed, risk remains that total abatements and the amount abated for each component of tax liability (tax, interest, and penalty) will be misstated.

## Other Matters

### Audits and refund

SAO followed up on two audits based on staff concerns that the former commissioner had interfered in or terminated the audits. There is no evidence that the former commissioner interfered in or terminated either audit.

For one audit, SAO found that a revised tax assessment was issued that lowered the amount due, but the records showed the revision occurred because the VDT auditor discovered she had made errors in the calculation of the tax owed. Further, because of the position taken by the taxpayer, a subsequent assessment was issued that increased the tax liability and the case is currently undergoing the appeal process.

For the second audit, the records provided by VDT and copied by SAO from the original auditor's files showed that the department pursued one of two issues identified by the first auditor on the case. The department ultimately did not issue an assessment. VDT's policy group determined that the law associated with the particular tax was ambiguous in some areas and required modernization in others. The second issue was not pursued and there was no documentation that explained the department's reason.

There was no evidence of interference or termination of the two audits by the former commissioner, but we noted that the department has limited guidance on audit processes. SOP 2016-03, effective 12/13/16 (replaced SOP 2015-24), addresses how to handle referrals, including whether they will be considered further for a potential audit and the position level responsible for determining whether a referral will be assigned to a VDT auditor. The department does not have other guidance that addresses determination of

audit scope, who is responsible for supervisory review, audit termination, and at what point, if any, senior officials should be involved in the audit process. As previously mentioned, policies and procedures are critical, setting the fundamental framework and underlying methods and processes all employees rely on to do their jobs. They provide specific direction to and help form the basis for decisions made every day by employees.

Staff also mentioned concern that a refund allowed by the former commissioner was not consistent with the law. However, ambiguity in the same law, relevant to the second audit, was highlighted in a department policy memo. According to documentation provided by VDT, a refund associated with a revised tax return was allowed because of this ambiguity in the law. The policy memo suggests that the appropriate course of action is to propose changes to the statute. VDT provided SAO an edited version of the relevant statute, but the former commissioner did not recall the department having specific language for legislation. She thought she raised the issue with the administration, but it never went anywhere. SAO reviewed the current version of the statute and no changes were made to address the issues pointed out in the policy memo during the period we audited or subsequently.

#### Vermont Tax Advisory Board (VTAB)

The VTAB was established in 2012 to provide 1) a public forum for communication between the Commissioner of the Department of Taxes and representatives of the public interested in Vermont's tax administration and policy; 2) ideas, input, and perspective to assist in developing tax policy and identify improvements in administration of taxes; and 3) constructive observations regarding current or proposed policies.

We noted that an attorney who represented a taxpayer in a dispute with the department that was settled in 2016 had been on VDT's Tax Advisory Board (VTAB) since its inception.

Federal rules<sup>30</sup> that address agency advisory committees require agency heads to assure that the interests and affiliations of advisory committee members are reviewed for conformance with applicable conflict of interest statutes, regulations issued by the Office of Government Ethics, and other federal ethics rules. A VDT document that addresses the purpose of the board indicates that topics for discussion will not include specific taxpayer matters but does not otherwise address conflicts of interest or state ethics rules. According to VDT General Counsel, there is no conflict of interest policy for the VTAB. The former commissioner explained that the board had been modeled on a program in place in another state and the lack of a conflict of

<sup>30</sup> 41 C.F.R. §102-3.105

interest policy may be because the model followed by VDT did not include one.

Without a conflict of interest policy to address such circumstances, there is increased risk that members of the board may provide tax policy advice that is overly influenced by their legal advocacy or the perception could develop that taxpayers receive more favorable results in matters before the commissioner if their representative is on the VTAB.

## Conclusions

The Commissioner of VDT is authorized to waive, reduce, or compromise any taxes, penalties, interest, or fees within his or her jurisdiction and must make a record of the reasons for doing so. Statute, department SOP, and rules provide guidelines for reasons that tax liabilities may be waived, reduced, or compromised. SAO found that for 36 of 59 abatements reviewed, VDT's documented reason was consistent with statute, department policy, or rules. However, reasons for these abatements were not documented in a systematic manner. For the other 23 abatements reviewed, VDT did not document a reason, cited a reason inapplicable to the circumstances, documented a reason inconsistent with policies, or documented a reason for only a portion of the amount abated. The lack of a consistent method of documentation makes it difficult for management to efficiently monitor the adequacy of the reasons for abatements, and the failure to document an adequate reason limits the department's ability to evaluate whether standards and criteria have been applied consistently to provide fair and equitable treatment for taxpayers, a stated purpose of the department's abatement policy.

Several shortcomings in the VTax data led us to conclude that the data was not reliable for the purpose of presenting summary amounts of abatements and write-offs for BIT, CIT, SUT, and MRT for calendar years 2015 and 2016. These limitations included: no distinction between abatements and write-offs in 2015 and most of 2016, transactions VDT recorded as abatements that were not abatements, and abatements not recorded timely. While VDT has worked to address some of these limitations, efforts are needed to resolve the other issues in order to reduce the risk that total abatements and the amount abated for each component of tax liability (tax, interest, and penalty) are misstated.

## Recommendations

We make the recommendations in Table 4 to the Commissioner of the Vermont Department of Taxes.

**Table 4: Recommendations and Related Issues**

Recommendation	Report Pages	Issue
<p>1. Develop and implement written guidance for VDT staff that establishes a standard methodology for documenting the reason(s) for abating tax liabilities, including when use of a reason code is sufficient, when it is necessary to add explanatory information in the VTax adjustment notes field and what that information should consist of, and to what extent external documentation is necessary.</p>	<p>16-17, 18-19</p>	<p>For 39 percent of abatements reviewed by SAO, VDT had not documented or partially documented reasons or the documented reasons were not consistent with statute, VDT policy, or rules. For the remaining abatements reviewed by SAO, VDT had documented reasons that were consistent with statute, VDT policy, or rules but the method of documentation was not systematic. Some reasons were documented via reason codes and the adjustment notes field in the VTax data. Others had reason codes and source documents. In addition, the source documents varied and included one or more of the following: internal VDT emails, Commissioner’s ruling in an appeal, correspondence with the taxpayer, or policy or legal memos. DFM’s internal control guide specifies that documentation of policies and procedures is critical to the daily operations of a department and provides specific direction to and helps form the basis for decisions made by employees. VDT’s SOP 2002-01, “Abating Tax Liabilities” did not address the statutory requirement to document a reason for abatement. The current version of the SOP incorporates this requirement but does not address how to document the reasons.</p>
<p>2. Develop and document definitions for the reason codes.</p>	<p>15, 18-19</p>	<p>Reason codes were inconsistent with information contained in VTax notes fields, did not reflect the actual reason for abatement, or were not specific enough to conclude they reflected the reason for abatement. An updated abatement policy does not include definitions for reasons codes. Codes were intended to be self-explanatory, but some signify processes, such as administrative decision and settlement, not reasons for abatements.</p>
<p>3. Consider whether VDT culpability for delays in resolution of taxpayer appeals should be explicitly addressed in the current SOP for abatements and write-offs and, if warranted, add guidance to the SOP for when it is appropriate and the amount of tax liabilities that may be abated for this reason.</p>	<p>17</p>	<p>One of the reasons documented by the former commissioner for an abatement in a settlement case was VDT culpability in delays. SAO concluded it did not seem unreasonable to consider VDT culpability in delays, but this reason is not addressed in VDT’s policy on abatements and is not explicitly stated in the factors to be considered in a settlement.</p>

Recommendation	Report Pages	Issue
4. Develop and implement procedures to document that VDT has conducted the evaluation of settlements required by VDT Rules of Procedure CVR 10-060-028, Rule 4(b).	18	Rules of Procedure CVR 10-060-028, Rule 4(b), requires that VDT consider a series of factors when evaluating a settlement proposal. Department officials told us that the five factors are considered and discussed when evaluating settlements, but there was no documentation of how each of the factors were applied. The rule does not specify that the five-factor evaluation be documented. However, the DFM's internal control guidance for managers indicates that documentation preserves evidence to substantiate a decision, event, transaction, or system and documentation should be complete, accurate, and recorded timely. Without documentation of the evaluation, the department lacks a record that demonstrates how VDT balanced the risk of litigation, equity among taxpayers, and ability to enforce tax law in the future. Further, the department does not have a clear record to demonstrate compliance with the rule that requires the five-factor evaluation.
5. Determine which approval levels the department should use, VTax permissions or the thresholds established in SOP 2016-02, and implement a single set of approval levels for abatements.	19-20	Abatements were not authorized at the requisite staff level per SOP 2002-01, in effect for 2015 and most of 2016. There is a discrepancy between approval requirements in SOP 2002-01 and permissions for approving transactions established in VTax. There continues to be inconsistency between the approvals in the updated SOP, 2016-02, and VTax.
6. Develop written guidance that explains which adjustments to tax liabilities are not traditional abatements or write-offs but will be recorded as such in the VTax adjustment module. Specify which, if any, existing reason code may be used just for these transactions or add another reason code for this purpose.	24	SAO found that several transactions selected for testing from the data extracts were neither an abatement nor a write-off though the information in the data extracts indicated they were one or the other. VDT agreed that the transactions were not traditional abatements or write-offs and explained that the transactions were the result of three different circumstances in which VDT had determined to use the VTax adjustment module to reduce these tax liabilities. The result is a misstatement of total abatements. SAO also found that the department had not provided guidance to department staff about how to record these types of adjustments and hadn't implemented a way to identify the transactions. As a result, the department does not have a way to determine the extent to which abatements are overstated by these transactions.
7. Assess the significance of abatements for NRW related to businesses with nonresident owners that are corporations. Document the assessment and decide whether to configure VTax to delay billing to allow review by VDT.	24-25	VTax is not currently configured to delay billing for deficiencies in nonresident withholdings by businesses when nonresidents include corporations. Because the system is not configured to delay billing for all nonresident owners to allow for a manual review before issuing a bill, there is potential for unnecessary bills to be issued and abatements to be overstated.

Recommendation	Report Pages	Issue
<p>8. Develop and implement written guidance for VDT staff that requires the following:</p> <ul style="list-style-type: none"> <li>- timely recording of abatements; and</li> <li>- abatements recorded in VTax reflect the amount of tax, interest, and penalty that VDT agreed to abate and that if payments are received in advance, that VTax users must specifically force the abatement or write-off onto the "paid" transactions.</li> </ul>	<p>26 - 27</p>	<p>An abatement was not recorded in VTax in a timely manner and another was processed in the legacy system as a change to the audit assessment and not as an abatement, as it should have been. As a result, abatements were understated by more than \$1.7 million.</p> <p>The amounts recorded in VTax for abatements did not equal the amounts VDT agreed with taxpayers would be abated for tax, interest, and penalty for two sample items. VDT explained that this could occur because of the VTax convention that applies taxpayer late payments first to interest and penalty, and then tax. Often tax is the unpaid balance because the other elements took priority for payment offset. If the VTax user does not specifically force the abatement or write-off onto the "paid" transactions, the reductions to the various components of tax liabilities in VTax will not match what is in supporting documents.</p>
<p>9. Develop and implement an audit manual that addresses determination of audit scope, supervisory review, audit termination, and circumstances, if any, that require senior official involvement.</p>	<p>27-28</p>	<p>The department has limited guidance on the audit process. The department does not have other guidance that addresses determination of audit scope, who is responsible for supervisory review, audit termination, and at what point, if any, senior officials should be involved in the audit process. As previously mentioned, policies and procedures are critical, setting the fundamental framework and underlying methods and processes all employees rely on to do their jobs. They provide specific direction to and help form the basis for decisions made every day by employees.</p>
<p>10. Develop and implement a conflict of interest policy for VTAB.</p>	<p>28-29</p>	<p>An attorney who represented a taxpayer in a dispute with the department that was settled in 2016 has been on the Tax Advisory Board since 2012. Without a conflict of interest policy, there is increased risk that members of the board may provide tax policy advice that is overly influenced by their legal advocacy or the perception could develop that taxpayers receive more favorable results in matters before the commissioner if their representative is on the board.</p>

## Matter for Legislative Consideration:

We make a recommendation to the Legislature in Table 5:

**Table 5: Recommendation and Related Issue**

Recommendation	Report Pages	Issue
1. Require that VDT document the evaluation of any settlement proposal, in particular the consideration of the five factors delineated in CVR 10-060-028, Rule 4(b).	18	According to the VDT General Counsel, there is no requirement to document the evaluation of settlement proposals that must be conducted per Rules of Procedure CVR 10-060-028, Rule 4(b). This rule requires that VDT consider five factors when evaluating a settlement proposal but does not specify that the evaluation be documented. Department officials told us that the five factors are considered and discussed when evaluating settlements, but there was no documentation of how each of the factors were applied. Without documentation of the evaluation, the department lacks a record that demonstrates how VDT balanced the risk of litigation, equity among taxpayers, and ability to enforce tax law in the future.

## Management’s Comments and Our Evaluation

On October 1, 2018 the Commissioner of the Department of Taxes provided comments on the draft report. The Commissioner’s response is reprinted in Appendix IV along with our evaluation of these comments (see pages 41 -43).

The Commissioner stated that the report provided many opportunities for improvements and that VDT is in the process of addressing the findings. The VDT Commissioner did not disagree with our characterization of the data in our report, with the exception of the reason for the reductions or elimination of NRW related tax liabilities which he indicated are “compelled by statute” but we concluded the reduction or elimination of these liabilities was an operational issue. He also disagreed with our conclusion that VTax could not be used to identify all NRW related abatements. The Commissioner stated that VTax could identify 95 percent of NRW-related abatements and the remainder could be identified via manual review. We address these differences and some other comments in our evaluation of management’s response in Appendix IV.



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## Appendix I

### Scope and Methodology

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To address our audit objectives, we gained an understanding of VDT's processes for administering adjustments of tax liabilities by reviewing their operating policies and procedures related to abatements and write-offs. We examined the department's "Standard Operating Procedures for Tax Liability Abatements" 2002-01 and "Standard Operating Procedures Tax Liability Abatements and Write-Offs" 2016-02, effective December 13, 2016. We reviewed VTax system manuals showing how to make adjustments. We interviewed VDT personnel, including senior management, to gain an overview of the systems and procedures used in creating and overseeing adjustments.

We observed a demonstration of the abatement and write-off process directly in the VTax system and of controls over data entry during the adjustment process. We also observed a demonstration of procedures for making manual reversals.

To gain an overview of the department, we reviewed budget documents for information on staffing and organization. We reviewed the department's Strategic Plan. We also reviewed reports prepared by the department and by the Internal Revenue Service (IRS). We also examined the contract for the VTax system.

We reviewed Vermont state statutes regarding the authority of the commissioner to adjust tax liabilities and statutory requirements for documenting these adjustments. Additionally, we reviewed statutes on corporate income taxes, business income taxes, sales and use taxes, and meals and rooms taxes. We reviewed the Code of Vermont Rules which prescribes the rules of procedure, including appeals, for the department.

We also reviewed reports of the American Institute of Certified Public Accountants, Vermont's Blue Ribbon Tax Structure Commission, and the Congressional Joint Committee on Taxation that addressed fairness and equity in the administration of taxes. For best practices related to internal controls, we reviewed the Vermont Department of Finance and Management document, "Internal Control Standards: A Guide for Managers."

We interviewed 23 current and former VDT staff regarding VDT practices in the administration of abatements. We also interviewed the former commissioner who was commissioner during 2015 and 2016, the period covered by the audit.

We obtained data extracts of the VTax system from VDT for all adjustments of BIT, CIT, MRT, and SUT during calendar years 2015 and 2016. The data extracts provided by VDT included two adjustment types that were

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## Appendix I

### Scope and Methodology

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automated, small balance adjustments and system write-offs, and two that were processed by VDT staff, abatements and write-offs.

We utilized guidance from the U.S. Government Accountability Office<sup>31</sup> to develop our approach for evaluating the reliability of the VTax data. Consistent with this guidance, we gained an understanding of the data elements in the VTax data extracts through interviews of VDT staff, including the VDT project manager for the VTax implementation, and inquiries of VDT personnel about various data elements. We reviewed standard VTax adjustment reports for the period January 1, 2017 to March 31, 2017. We also requested descriptions of data tables and definitions of fields within those tables. We requested VDT describe the types of adjustments processed in VTax and in previous tax systems (Advantage Revenue and ETM), such as abatements, write-offs, and system write-offs, and that VDT provide written descriptions for the reason codes being used to describe each adjustment.

Because the data in the extracts came from the VTax reporting database, and not from the original production database, we reviewed the process used by VDT to transfer the data from one database to the other. To validate the completeness of the extracts, we reviewed VDT's queries used to extract the data from the VTax system and validated that the queries extracted the characteristics, fields, and date ranges that we had requested. We observed VDT rerun the queries and found no significant differences between the original data extracts as provided to SAO and the data from the second execution of the queries. To validate the accuracy of the data in the extracts, we selected a sample of 30 adjustments and traced the data in the extract to the screens in the VTax system showing the origin of that data. We found that in all cases, the data in the data extract could be traced to the data in the VTax system production database.

We utilized various data fields in the extracts to sort the data into subsets; small balance adjustments, system write-offs, BIT abatements related to NRW, and all other abatements and write-offs. Based on the characteristics of the subsets, we performed tests to address the first audit objective.

#### Small Balance Adjustments

We sorted the data extracts for the adjustment type known as "small balance adjustments" and excluded the subset from further testing as these are automated write-offs for amounts below a specific dollar amount and the total was less than one percent of the total dollars adjusted in 2015 and 2016.

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<sup>31</sup> *Assessing the Reliability of Computer-Processed Data* (U.S. Government Accountability Office, GAO-09-680G, July 2009).

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#### System Write-offs

According to VDT, VTax was programmed to write-off tax liabilities once the period for collection allowed by statute has expired. VTax also was programmed to write-off certain tax liabilities generated from processing backlogged returns in VTax, for example tax liabilities that had not been billed within three years of the later of the return due date or filing data. To assess whether system write-offs conformed to the logic that VDT described, we sorted the VTax data by adjustment type “system write-off” and selected 15 transactions. For the sample items, we obtained supporting documentation to substantiate the data points used by the VTax system in determining whether to make the write-off. We compared these data points to the system rules to determine compliance with the rules. We found no issues in our testing. We reviewed statute to verify that the logic described by VDT was consistent with statutory provisions for collecting and assessing tax liabilities.

#### Abatements and Write-Offs

Based on interviews with and inquiry of VDT staff, we noted that BIT abatements were significantly impacted by NRW which VDT ultimately determined had been paid by the business entity owners and VDT abated the amount billed to the business. We concluded that due to the nature of these transactions, they were not abatements. According to VDT, it is possible to identify some BIT abatements related to NRW, but not all so it isn't possible to quantify the amount that BIT abatements were misstated in 2015 and 2016. To the extent possible, we identified BIT abatements related to NRW by sorting the VTax data based on specific source transaction types<sup>32</sup> that VDT indicated were specific to NRW transactions and others that VDT explained when used with BIT, signified the transaction is NRW.

From the subset that could be identified, we picked a sample of 15 transactions based on the reason code for the abatement and the percentage of total dollars abated for that reason code. We confirmed that the abatements were NRW-related and were the result of owners paying NRW rather than the business, we obtained VTax notes for each transaction from VDT and we analyzed each transaction to determine the basis for making the adjustment.

For the remainder of the adjustments, categorized as abatement or write-off and recorded by VDT staff, we selected a non-statistical sample of 70 transactions. The selection was based on various characteristics, including amounts greater than \$50,000, reason code, approver, tax type, and liability

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<sup>32</sup> Source transaction type is a field in VTax that describes the source of the financial transaction to be adjusted such as original return tax, late payment interest, underpayment interest, late payment penalty, and audit tax.

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## Appendix I

### Scope and Methodology

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adjusted (penalty, interest, or tax). Adjustments of SUT and MRT were processed in the previous tax system for most of 2015 and were known as abatements. For these, we selected amounts above \$50,000 and six additional transactions by picking each 200<sup>th</sup> item in the population of MRT abatements and each 125<sup>th</sup> item in the population of SUT abatements, omitting any under \$400.

Six additional abatements, one of which was part of the non-statistical sample, were brought to the attention of SAO by current and former staff who believed the abatements were not justified.

For each sample item and the five additional abatements, we reviewed the reason code selected and VDT staff notes from the applicable system – VTax or previous tax system, where applicable. We reviewed other supporting information such as settlement documents and judgement documents, where applicable. We also obtained VDT comments on each sample item. Based on these sources, we identified the reason for abatement documented by VDT. We compared the reason for abatement to criteria in statute, VDT policies or rules, to assess the extent to which VDT’s reason for abating tax liabilities was consistent with these criteria. To assess the reliability of the reason code for the sample items, we compared the reason code to VDT staff commentary in the adjustments notes field and to external documentation.

Based on this testing, we determined that 16 of the 70 selected were not traditional abatements and these were excluded from further analysis. We found that one abatement was not recorded timely and another transaction was not recorded as an abatement but should have been. We found that the categorization of the abatement amount as penalty, interest, or tax was incorrect for two sample items. We also concluded that the BIT abatements related to NRW were not abatements and that it was not possible to utilize the information in the data extracts to identify the full impact of these transactions on BIT abatements, so the total misstatement could not be determined.

During the course of the audit, VDT disclosed that they did not distinguish between abatements and write-offs during 2015 and 2016. According to the department, “Under the previous SOP, abatements and write-offs were used interchangeably.” The failure to distinguish between these transactions and the results of our detail testing of the adjustments categorized as abatements and write-offs in the VTax data extracts led us to conclude that the data was not reliable for purposes of the second audit objective – summarizing the amount of abatements and write-offs for certain business tax liabilities in calendar years 2015 and 2016. As there is no alternate source of data, we presented the data, with a disclaimer that the data was not sufficiently reliable for purposes of the audit objective.

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## Appendix I

### Scope and Methodology

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We also assessed whether the items in the sample were approved by VDT staff with requisite approval per the department's SOP on tax liability abatements. We obtained the VTax system configuration which shows the amount of an adjustment that each employee could approve. We compared the system configuration to the approval thresholds as outlined in the VDT SOP and noted any discrepancies. To assess whether changes to approval authority in the department's revised SOP for tax liability abatements and write-offs had lowered the rate at which abatements were processed in VTax without the required approval, we reviewed abatements and write-offs from January 1, 2017 to March 31, 2017. We selected a non-statistical sample and analyzed the adjustments according to the criteria specified by the newly released procedure.

We performed our audit between February 2017 and August 2018 primarily in Montpelier, Vermont.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Appendix II Abbreviations

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BIT	Business Income Tax
CIT	Corporate Income Tax
CVR	Code of Vermont Rules
DFM	Department of Finance and Management
LLC	Limited Liability Company
MRT	Meals and Rooms Tax
NRW	Nonresident Withholding
SAO	State Auditor's Office
SOP	Standard Operating Procedure
SUT	Sales and Use Tax
V.S.A.	Vermont Statutes Annotated
VDT	Vermont Department of Taxes
VTAB	Vermont Tax Advisory Board
VTax	Vermont Tax Enterprise System

## Appendix III Reason Codes

Table 6 lists the reason codes included in SOP 2016-02, effective December 13, 2016, that were also available in VTax and one additional reason code that was in VTax, but not included in the SOP. Two reason codes, “Commissioner Determination” and “Incarceration,” were included in the SOP, but were not in VTax. According to VDT, the codes were planned to be added to VTax. The table also includes the SOP guidance about whether the codes were applicable to abatements, write-offs, or both.

Definitions were not in the SOP but were provided by VDT upon SAO request.

**Table 6: Reason Codes**

Reason Code	Definition	Abatement	Write-Off
Administrative Decision	Generally used when other reasons are not applicable	X	
Amnesty	No definition provided.		
Bankruptcy Discharge	After a bankruptcy discharge has been received from court.		X
Billed in Error	Limited instances where an abatement is appropriate to correct a billing error.	X	
Business Closed	No definition provided.	X	
Converted Adjustment	Most transactions labeled CV adjustment were from a function in the previous system known as tax assessment, which was used to achieve the correct tax liability in a period.	X	X
Court Order	No definition provided.		X
Equitable Relief	Used for first late filing or return error for a business or a review of taxpayer’s history shows de minimus mistake.	X	
First Time Audit	No definition provided.	X	
First Time Taxpayer Late Payment	No definition provided.	X	
Hardship Case	Evidence shows that pursuing collection would create a hardship on the taxpayer. Examples include taxpayer becomes homeless, goes on disability, has no assets due to limited income, is incarcerated, or has a severe medical diagnosis.	X	
Offer & Compromise	Settlement for less than full payment and usually based on ability to pay.	X	
Past Statute	Bill has exceeded statute of limitations for collection.	X	
Reasonable Cause	Causes such as mail delivery problems, delay due to death of taxpayer or immediate family, or natural disaster that destroyed taxpayer records.	X	
Settlement	The resolution of a contested matter.	X	
Statutory Exemption	Non-resident withholding transactions and case-by-case statutory exemptions.	X	X
Uncollectible	No definition provided.	X	
Adjustment Agreement <sup>a</sup>	No definition provided.		

<sup>a</sup> Not included in SOP 2016-02. According to VDT staff, adjustment agreement is not available as a reason code for abatements or write-offs.

# Appendix IV

## Reprint of Management’s Comments and SAO

The following is a reprint of Commissioner Samsom’s response to a draft of the audit report we provided to VDT for comment and our evaluation of those comments. See page 43 for SAO’s evaluation.



**State of Vermont**  
**Department of Taxes**  
133 State Street  
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*Agency of Administration*

October 1, 2018

Douglas Hoffer  
Vermont State Auditor  
Office of the State Auditor

Dear Auditor Hoffer,

Thank you for your review of the practice of abatements of Business tax liabilities in calendar years 2015 and 2016 at the Vermont Department of Taxes (VDT). For both business taxpayers and the VDT, the administration of taxes is complex and challenging. As the VDT strives to collect all taxes owed and thus ensure a level playing field among competing businesses, we frequently encounter instances where tax, penalty or accrued interest (collectively: “tax liabilities”) have been improperly or inappropriately applied. Statute provides the Commissioner with broad authority and discretion to ensure that taxpayers are treated fairly in these situations. For instance, while penalties and interest on late or underpaid taxes are routinized in the VDT processes, the statute does not compel the Commissioner to assess penalty; rather, it states that the Commissioner “may” assess penalty and interest. Furthermore, and as noted in your report, the Legislature has granted the Commissioner broad authority to reduce or eliminate tax liabilities, provided the VDT document a reason for the abatement.

The State Auditor’s Office (SAO) team provided VDT helpful insights and pointed to potential areas of improvement. However, the VDT is concerned that the report may lead to some misunderstandings of the current situation. The focus of the audit centered on a period of comprehensive technological and administrative transformation at the VDT. Many of the abatements included in the report’s figures are for liabilities that are statutorily uncollectible. Additionally, the targeted nature of the non-statistical sample for which SAO provided percentages should not be extrapolated by readers to represent the broader abatement activities of the VDT.

The audit focused on abatements that occurred in 2015 and 2016 and were governed by a Tax Department Standard Operating Procedure (SOP 2002-01 “Tax Liability Abatements”) developed in 2002. Additionally, 2015 and 2016 were two years that saw what would certainly rank as one of the most transformative IT projects in the history of the Tax Department. Not only were all 30 tax types in the process of being transferred into the new VTax IT system, but the way our staff does business also underwent significant change. As part of that process, a data cleanup effort resulted in the identification of many uncollectible accounts. That cleanup effort is not representative of VDT’s current landscape.

Although many findings are valuable, it is important to note that the Tax Department now operates under a different SOP, under different leadership, and in a more stable environment where VTax is fully implemented. As you are aware, when the SAO started the audit, the 2002 SOP your team relied on had already been superseded. And, the 2016 SOP is being revised now, as VDT’s processes are settling into this new technological environment and in response to certain findings from this audit.

Regarding some of the specific findings, VDT would like to add some important context. In some instances, VDT is not exercising discretion in reducing or eliminating a tax liability, but rather the statute itself compels the Department to do so. This is the case in taxes assessed per non-resident withholding requirements, which are

SAO Comment 1

SAO Comment 2



[www.tax.vermont.gov](http://www.tax.vermont.gov)



# Appendix IV

## Reprint of Management's Comments and SAO



**State of Vermont**  
**Department of Taxes**  
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*Agency of Administration*

noted in the SAO report. Nearly \$27 million of the \$48 million of abatements cited in the SAO report were non-resident withholding abatements, which, in accordance with Vermont law, are often abated when the owners of businesses file and reconcile at year-end.

Additionally, there are situations where VDT no longer has the authority to collect a tax liability, such as in the case of an expired statute of limitations or bankruptcy discharge. In these situations, VDT no longer has authority to collect these amounts; and, if we had chosen to pursue collection, we would have almost certainly ended up in court and lost.

Finally, of the thousands of adjustments made every year, SAO selected 59, which were based on SAO's review of the data and interviews VDT staff about specific cases. Given the selection methods, SAO notes that the sample is non-statistical; and for that reason results should not be extrapolated to all VDT abatements.

The inclusion of legally mandated write-offs in the report's findings, the vastly different environment the Department operates in now versus your sample period, and the fact that the SAO used a non-statistical sample could leave a reader with the incorrect impression that the reported results represent an error rate for all abatements, that abatements were inappropriate, or are a reflection of the current state of affairs at the Tax Department. That, of course, is not the case.

VDT also wants to address the data questions the SAO raised. The VTax system has drastically improved the Department's position with regards to data and analytics. VDT believes the data issues the SAO raised were low impact, temporary, or a direct result of the novelty of the VTax system for the years involved with the audit. For instance, SAO contends that VTax is incapable of identifying all NRW-related abatements, but the Department disagrees. VTax can identify over 95% of NRW-related abatements through a query alone, and the remaining abatements can be identified via manual review. This need for manual review is not due to a deficiency in the VTax technology, but because two types of liabilities are collected on one business income tax return. VDT collects those liabilities together to make it simpler for businesses operating in Vermont to comply with the tax requirements. Additionally, the SAO focused on what was defined as a non-traditional abatement. The report indicates that the majority of these are adjustments to liabilities converted from our old system, a scenario that will naturally cease to occur as the Tax Department gets further from the final conversion date.

While there is work to do to better align the new SOP with user abatement authority in the new integrated tax system, the Tax Department is in a much better position in 2018 to consistently and fairly apply abatement authority and document these adjustments. The report has provided many opportunities for improvement, and VDT is in the process of addressing these findings. Thank you again for your and your staff's efforts and work with the Tax Department as we all strive for a fair and efficient tax system.

Sincerely,

  
Kaj Samsom  
Commissioner  
Vermont Department of Taxes



[www.tax.vermont.gov](http://www.tax.vermont.gov)

SAO Comment 3

SAO Comment 4

SAO Comment 3

SAO Comment 5

## Appendix IV Reprint of Management’s Comments and SAO

### SAO Evaluation of Management’s Comments

SAO Comment Number	SAO Evaluation
SAO Comment 1	We utilized the standard operating procedures that were in effect for the period covered by our audit scope.
SAO Comment 2	Most of the \$26.7 million reduction of NRW-related tax liabilities was due to an operational issue that arose because VTax was not configured to determine whether deficiencies in NRW payments by businesses were offset by payments that had been made via nonresident owners’ personal income tax filings. The department was compelled to make these adjustments, but it was because they needed to correct for unnecessary bills.
SAO Comment 3	The Commissioner refers to instances where the department “no longer has the authority to collect a tax liability, such as in the case of an expired statute of limitations or bankruptcy discharge” and objects to the inclusion of “legally-mandated write-offs in the report’s findings.” However, these transactions are included in the abatements reported in Table 3 because the department informed us write-offs and abatements were used interchangeably and the department lacked a definition for abatement or write-off until December 13, 2016. Because of this, we concluded that the data provided by VDT could not be used to identify those instances where VDT exercised its authority to reduce a monetary amount legally due the department (i.e., abatement) versus those circumstances where the department no longer had the authority to collect tax liabilities (i.e., write-off). We reported this as a data reliability issue.
SAO Comment 4	<p>We selected a sample of 70 and added five additional abatements based on interviews with current and former VDT staff. Of the 75 selected, 16 were not traditional abatements which reduced our sample to 59. VDT’s use of the adjustments module to record these non-traditional abatements was one of multiple data reliability issues that led us to conclude we could not rely on the data provided by VDT for purposes of summarizing the amount of abatements and write-offs in calendar years 2015 and 2016.</p> <p>Our judgmental sample was a subset of the data extract provided by VDT as described in our scope and methodology. The dollar value of our sample represented over 40 percent of the dollar value of abatements in this subset.</p>
SAO Comment 5	The Commissioner contends that the data issues were “low impact, temporary or a direct result of the novelty of the VTax system” and he focuses on the reliability issues we reported for NRW abatements and the non-traditional abatements. However, these are just two of many data reliability issues that we noted in the report all of which taken together led us to conclude that the data was not reliable for purposes of our audit objective. With respect to the NRW abatements, we concluded that many, but not all of the NRW abatements could be identified via the use of specific codes in a VTax field. This is not inconsistent with the Commissioner’s statement that “VTax can identify 95 percent of the NRW-related abatements through a query alone, and the remaining abatements can be identified via manual review.” However, we do not know how the Commissioner derived this percentage and we are skeptical that the department could utilize a manual review process to identify the remaining transactions, because we identified over 27,000 business income tax abatements totaling \$2.6 million in 2015 and 2016 that did not have the specific NRW codes and would need to be reviewed manually.