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October 26, 2011

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: September 2011 Special Session Senate Bill 23 and Assembly Bill 23: Department of Revenue Tax Administration

September 2011 Special Session Senate Bill 23, which would modify certain provisions related to Department of Revenue (DOR) tax administration activities, was introduced on October 18, 2011, and referred to the Senate Committee on Public Health, Human Services, and Revenue. September 2011 Special Session Assembly Bill 23, which is identical to SS SB 23, was introduced on October 18, 2011, and referred to the Assembly Committee on Ways and Means.

CURRENT LAW

DOR is required to office audit individual income and corporate income/franchise tax returns as it deems advisable. An office audit does not preclude the Department from making field audits of the books and records of the taxpayer or from making further adjustments, corrections, and assessments of income. DOR is required to conduct an income and franchise tax field audit whenever the Department deems it advisable to verify any return directly from the books and records of any person, or from any other sources of information. The Department is also statutorily authorized to conduct office and field audits of state sales, use, and excise taxes.

Typically, office audit programs are based on information generated from the data bases included in the Department's data warehouse. The data warehouse is linked to the Wisconsin income and tax processing system (WINPAS), and includes information from state and federal tax returns, other tax forms, such as 1099 forms, filed by employers and taxpayers, and information from other agencies, such as motor vehicle license data from the Department of Transportation. Examples of office audit projects would be comparing federal adjusted gross income to the amount reported on Wisconsin returns, or computer matching of alimony deductions to alimony income claimed on individual tax returns. Other programs would include comparing information reported

by businesses on sales tax returns with the same items reported on federal and state income and franchise tax returns, and reviewing seller and buyer claims for refunds of sales, use, and stadium taxes.

The basic steps usually taken by DOR in conducting an office audit and in making an assessment or refund adjustment are:

a. The Department examines returns and tax credit claims to check the correctness of the items reported.

b. DOR may request more information or receipts to clarify or support certain items.

c. The Department decides if an adjustment to the return is necessary, and if so, the taxpayer may owe an additional amount or receive a refund.

d. The taxpayer is sent either an assessment explaining the amount due, or a notice of refund explaining the refund to be issued. The notices show the amount of tax, interest, and penalty (if any), or refund, and explain the taxpayer's appeal rights.

Field audits are often based on information generated from the data warehouse, including comparisons of corporate apportionment formula components, such as total sales, to similar items reported on federal returns. Field audits can also be initiated based on findings in office audits, referrals from field staff, Internal Revenue Service (IRS) staff or other sources, and on issues identified in previous audits. DOR distinguishes between large case and district size audits based on a company's assets ($50 million or more). DOR's Audit Bureau reviews sales/use and franchise/income tax returns of the largest taxpayers, and determines whether a sales/use tax field audit is appropriate on a rotating basis (every four years). The Bureau may determine, based on reviewing returns and prior adjustments, that there are not significant compliance issues that warrant an audit.

The following procedure is generally taken by DOR in conducting a field audit and making an assessment or refund:

a. DOR sends a letter notifying the taxpayer that the relevant tax returns have been selected for examination. The letter includes the date and time for the taxpayer's first meeting with the auditor. At the meeting, the auditor discusses the nature of the taxpayer's business or employment, the accounting or record keeping system used, and other related matters.

b. An auditor will examine the tax returns and the taxpayer's books and records to determine if the correct amounts were reported on the tax returns. If possible, the audit will be conducted at the taxpayer's place of business. In some cases, the auditor will obtain information from third-party sources.

c. After completing the examination, the auditor may determine that adjustments should be made that result in an amount due or a refund. The auditor generally discusses the proposed audit

report in a final conference, and a complete copy of the proposed report is then given to the taxpayer and the taxpayer's representative. The taxpayer is requested to sign a Notice of Proposed Audit Report form indicating full or partial agreement, or total disagreement with the proposed adjustments.

d. The auditor's proposed field audit report and work papers are reviewed by the Department's central review staff for correctness, uniformity, and proper application of the law.

e. DOR notifies the taxpayer by mail of the results of the field audit. If there are adjustments, the taxpayer will receive an assessment or refund notice. The notice and report will explain the adjustments, the amount of tax, interest and penalty (if any), and the taxpayer's appeal rights. If the field audit results in no amount due and no refund, a letter of notification is sent to the taxpayer explaining that there is no change.

If a taxpayer disagrees with adjustments made to the tax return by DOR, the taxpayer has the following options;

a. Pay the full amount of the assessment without filing an appeal. The taxpayer may contest some or all of the adjustments at a later date by filing a claim for refund. A claim for refund of income and franchise taxes may be filed within four years from the date the assessment was issued. In general, a claim for refund of sales and use taxes must be made within two years after an office audit assessment, and within four years of a field audit assessment. (Sales tax refunds must be passed on to customers based on their valid refund claims.)

b. File an appeal with the Department of Revenue. The appeal must be made within 60 days after the date the taxpayer received the refund or adjustment notice. A taxpayer may stop or limit the accumulation of interest on amounts owed by: (1) depositing the entire amount of the additional assessment, including interest and penalty, with DOR, when filing an appeal, or any time while the appeal is pending; or (2) pay any portion of the assessment that the taxpayer agrees with. Payment of a portion of an assessment is considered an admission of the validity of that part of the assessment, and may not be recovered from appeal, or any other action or proceeding.

A taxpayer has several levels of appeal that can be taken to contest DOR tax return adjustments. The levels of appeal, in order, are: (a) the Department of Revenue; (b) the Wisconsin Tax Appeals Commission; and (c) the courts.

Current statutory provisions specify the interest rates that apply to assessment amounts, delinquent amounts, and refunds. Unpaid taxes are subject to interest at 12% per year. When an unpaid or unreported tax is identified, a bill is sent to the taxpayer. If the bill is not paid or appealed by the due date (usually 60 days), the assessment is certified as delinquent and the delinquent collection fee (greater of $35 or 6.5% of balance due) and interest at 18% per year is imposed on the delinquent amount. Refunds of taxes paid by DOR include interest payments of 9% per year.

Penalties are imposed for negligence and fraud. Generally, a penalty of 25% of the relevant amount is imposed for willful neglect in failing to file, or filing an incorrect or incomplete return.

A penalty of 100% of the relevant amount is imposed if a return is not filed, or if an incorrect return is filed with intent to defeat or evade the tax.

Total general fund tax revenues were $12,911.9 million in fiscal year 2010-11. Of the total, $6,700.6 million was collected from the individual income tax, $4,109.0 million was collected from the sales and use tax, and $852.9 million was collected from the corporate income/franchise tax. About 6.3 million different types of tax and information returns were filed with DOR in 2010-11. Of the total number of returns filed, 2,928,700 were individual income tax, 1,859,700 were withholding tax, 958,200 were sales and use tax, and 157,200 were corporate income/franchise tax returns. In 2010-11, DOR conducted a total of 30,335 audits, of which 28,437 were office audits and 1,898 were field audits. The audits generated 30,484 assessments totaling $341.2 million. More specifically, there were 20,900 individual income tax assessments totaling $40.8 million, 874 corporate income/franchise tax assessments totaling $200.1 million, and 7,486 sales and use tax assessments totaling $78.8 million. Assessments may not be paid in the same fiscal year as issued, but can take several years to collect. In addition, assessments are certified as delinquent when the due date has passed, and statutory appeal rights have expired (generally 60 days after the due date). Delinquent taxes are collected by the DOR Compliance Bureau, rather than the Audit Bureau. Total audit collections in 2010-11 were $255.8 million, including $14.2 million in individual income taxes, $50.2 million in sales and use taxes, and $185.3 million in corporate income/franchise taxes. In 2010-11, a total of 399 negligence penalties were imposed through field audits of general fund taxes. The table below shows the total number of audits conducted by DOR and the total amount of assessments and refunds compared to total general fund tax revenues for fiscal years 2008-09 through 2010-11.

Number of Audits and Amounts of Assessments and Refunds

	2008-09	2009-10	2010-11
Number of Audits	30,368	28,547	30,335
Assessments	$386,517,700	$388,435,800	$341,187,300
Refunds	$30,554,500	$53,166,400	$34,277,400
Refunds Reduced	$29,862,900	$49,122,100	$39,827,500
Total General Fund Taxes	$12,113,151,000	$12,131,659,000	$12,911,865,000

SUMMARY OF BILLS

September 2011 Special Session Senate Bill 23 and Assembly Bill 23 would make a number of changes to statutory provisions that govern the tax administration activities of DOR. The following sections describe current law provisions and practices, and the proposed changes.

Effect of Nonacquiescence in a Tax Appeals Commission Decision. Under current law, DOR may choose not to appeal and to nonacquiescence in a Tax Appeals Commission decision or order.

The effect of such an action is that, although the decision or order is binding on the parties to the case, the Commission's conclusions of law, the rationale, and construction of the statutes in the case are not binding upon, or required to be followed by, DOR in other cases.

SS SB 23/SS AB 23 would allow the decision to be cited by the Commission and the courts in future cases. In addition, the bills provide that, except for decisions and orders in small claims matters, a conclusion of law or other holding in any decision or order of the Commission may be cited by the Commission or the courts as authority, unless that conclusion of law has been reversed, modified, overruled, or vacated on the merits on appeal, or by a subsequent decision or order of the Commission.

Reliance on Published Guidance. DOR relies on current statutes, administrative rules, and court cases for actions taken in audits, assessments, and claims for refund. Department publications provide guidance concerning the laws, rules, and court cases.

SS SB 23/SS AB 23 would provide that, in the course of a determination, or in the course of any proceeding appealing any determination, DOR would be prohibited from taking a position that was contrary to any rule promulgated by the Department that was in effect during the period related to the determination, or that was contrary to any guidance published by the Department prior to that period, unless it was subsequently retracted, altered, or amended by the Department or Legislature, or by a final and conclusive decision of the Tax Appeals Commission or courts.

Unless otherwise prescribed by the Legislature, Tax Appeals Commission, or court, DOR could retroactively apply any rule change that was related to implementing a legislative act or a final and conclusive decision of the Tax Appeals Commission, or court, to take effect no earlier than the act's effective date or the date on which the decision became final and conclusive, only if the Department submitted the rule's scope statement to Governor for approval as required under current law, no later than 18 months after the latter of the legislative act's publication date , effective date, or initial applicability date, or the date on which the decision became final and conclusive. Any other retroactive application of a rule change would have to be approved by the Governor, under current law administrative procedure and review provisions.

In the course of any determination, or any proceeding appealing the determination, DOR could not take a position that was contrary to any written guidance that was provided to a person who was a party to the determination or appeal regarding the same facts as in the determination, unless the guidance was subsequently retracted, altered, or amended by the Department or Legislature, or by a final and conclusive decision of the Tax Appeals Commission or courts.

In regard to any position taken by DOR in such determinations or appeals, if DOR retracted, altered, or amended previously published or previously issued written guidance for any purpose other than to implement a legislative act, or a final and conclusive decision of the Tax Appeals Commission or courts, the Department would be required to apply the retraction, alteration, or amendment prospectively. However, if the change was to the taxpayer's benefit DOR would be

required to apply the retraction, alteration, or amendment retroactively. A retroactive change in any previously published or previously issued written guidance that was related to implementing a legislative act, or final and conclusive decision of the Tax Appeals Commission or courts, could take effect no earlier than the act's effective date or the date on which the decision became final and conclusive, unless otherwise prescribed by the Legislature, or ordered by the courts.

"Published" would mean prepared and issued for public distribution, and would not include guidance on a private matter or issue. "Written guidance" would be defined as a written statement made by an employee of the Department acting in an official capacity regarding a Wisconsin tax question to the person or the person's representative.

"Person who is a party to the determination" would mean a person who requests a determination for that person's benefit, files a claim for refund, or is assessed by the Department, but not including any of the following: (a) a person who, on behalf of another person, requests a determination or a claim for a refund, or appeals a determination; (b) a shareholder of a tax-option corporation, a member of a limited liability company (LLC), or a partner of a partnership, unless such an individual is named or identified in the determination, claim for refund, or assessment; or (c) an anonymous person who requests a determination, claim for a refund, or assessment.

Reliance on Past Audits. In performing audits of specific items, such as deductions or credits, or in more extensive cases, the Department of Revenue typically reviews only the tax information relevant to that audit. In general, the Department does not conduct a full audit of all transactions and all information on a tax return. As a result, the Department does not attest to the accuracy of all the tax information reported by those taxpayers.

SS SB 23/SS AB 23 would provide that, a person who was subject to a determination by DOR, including, for corporate income/franchise taxes for tax years beginning after December 31, 2008, all other members of that person's controlled group (as defined under combined reporting provisions), would not be liable for any amount that DOR asserted was owed if all of the following conditions were satisfied:

a. The liability asserted by DOR is the result of a tax issue during the period associated with a prior determination for which the person is subject to and the tax issue is the same as the tax issue during the period associated with the current determination.

b. A DOR employee who was involved in the prior determination identified or reviewed the tax issue before completing the prior determination, as shown by any schedules, exhibits, audit reports, documents, or other written evidence pertaining to the determination, and the schedules, exhibits, reports, documents and other written evidence show that the Department did not adjust the person's treatment of the tax issue.

c. The liability asserted by the DOR was not asserted in the prior determination.

These provisions would not apply to any period associated with a determination that was subsequent to promulgation of a rule, dissemination of written guidance to the public or the person subject to the determination, or the effective date of a statute, or the date on which a Tax Appeals Commission or court decision became final and conclusive, if the rule, guidance, statute or decision imposed the liability as a result of the tax issue.

Negligence Determinations. Under current law, DOR is authorized to impose penalties for failure to file, late filing, or filing of incomplete or incorrect tax returns, reports, or other documents, unless these actions are due to reasonable or good causes, and not negligence. Some of the factors considered by DOR in determining negligence include: (a) results of prior audits; (b) the knowledge, education, and expertise of the person responsible for maintaining and preparing the taxpayer's records; (c) the taxpayer's awareness of the taxability of items, the need for exemption certificate requirements, and similar issues; (d) the nature of the items, including complexity and interpretations made; (e) the consistency and pattern in which adjustments occurred; (f) the adequacy of records and reporting systems; (g) the amount of taxes; and (h) the availability of written guidance. Statutory provisions require that the taxpayer has the burden of proving that errors were due to reasonable or good cause, and not due to neglect.

Under SS SB 23/SS AB 23, DOR could not impose a penalty for failure to file, late filing, or filing of incomplete or incorrect filing of returns, reports, and other documents, unless the Department could show that the taxpayer's action or inaction was due to the taxpayer's willful neglect, and not reasonable cause. As a result, DOR, rather than the taxpayer, would have the burden of proof in determining negligence. This change would apply to provisions under individual income, corporate income/franchise, sales, utility, insurance premiums, alcoholic beverage and beverage, motor fuel, aviation fuel, alternative fuel, tobacco and cigarette taxes.

Confidentiality of Tax Returns and Claims. Under current law, no person, except the person who filed a return or claim under the individual income tax, can inspect the return or claim, unless it is a person performing the duties of his or her position. Violation of this confidentiality provision by a state employee is grounds for dismissal. In addition, persons convicted of violating the provision are subject to a fine of between $100 and $500, and/or imprisonment for between one and six months. If a person is charged with violating the law, the Secretary of Revenue is required to notify each taxpayer whose tax return or claim was improperly inspected by that person. Any person who is notified may bring an action for damages related to the improper inspection.

SS SB 23/SS AB 23 would modify the current law confidentiality requirement to specifically apply to any information derived from a return or claim in addition to the return or claim. In addition, this provision and the penalty provisions would be extended to apply to returns, claims, and information derived from returns or claims under the estate tax, sales tax (including the county sales tax), special purpose district taxes (such as baseball park district taxes), local taxes (such as the rental car tax), economic development surcharge, dry cleaning fees, alcoholic beverage taxes and permits, cigarette taxes, and the tobacco products tax.

Under current law, it is unlawful for DOR and any person with an administrative duty in administering the sales tax to make known information obtained from retailers or other persons examined in the discharge of official duty the amount or source of income, profits, losses, expenditures or certain other information included in any return, or to permit the examination of a return by any person. DOR is authorized to publish statistics and using information from returns in legal proceedings.

SS SB 23/SS AB 23 would permit employees or agents of DOR to inform a buyer or seller who has filed a claim for refund of sales taxes that a refund has been paid to a seller or buyer with respect to the same transaction. The bill would extend this provision to the county sales tax, special purpose district taxes, local taxes, and the dry cleaning fee.

Petition for Rules. Under current law, a municipality, an association that represents a farm, labor, business, or professional group, or any five or more persons having an interest in a rule may petition an agency requesting it to promulgate a rule, unless: (a) the right to petition for a rule is restricted by statute to a designated group; or (b) the form of procedure for a petition is otherwise prescribed by statute.

An agency is required to either deny the petition in writing, or proceed with a request for rule making, within a reasonable time after receipt of the petition. If the agency denies the petition, it is required to promptly notify the petitioner of the reason for the denial. If the agency proceeds with rule making it must follow statutory procedures for promulgating rules.

Under SS SB 23/SS AB 23, if a petition for rules to DOR alleges that DOR has established a standard by which it is construing a state tax statute, but has not promulgated a rule to adopt the standard, or has published the standard in a manner that is available to the public, DOR would be required to submit a statement of scope of the proposed rule to the Governor within 90 days after receiving the petition. If the statement of scope was approved by the Governor, the Department would have to submit the proposed rule in final draft form, within 270 days after the statement was approved. Prior to expiration of the deadline for submitting either the statement of scope, and/or the final draft rule the Governor could, at DOR's request, extend the time limit, for any period up to 60 days. The Governor could grant more than one extension, but the total period for all extensions could not exceed 120 days.

The rule would not have to adhere to the standard established by the Department, but would be required to address the same circumstances that the standard addressed. If DOR failed to comply with these provisions, any of the petitioners could commence an action in circuit court to compel the Department's compliance. If an action was commenced under these provisions, the court could compel DOR to provide information to the court related to the degree to which the Department was enforcing the standard. However, information provided by the Department could not disclose the identity of any person who was not a party to the action.

Petition for Declaratory Rulings. Under current law, any interested person may petition any state agency to issue a declaratory ruling with respect to the applicability of any rule or statute

enforced by the agency to any person, property, or state of facts. Within a reasonable time after receiving the petition, an agency is required to either deny the petition or schedule the matter for hearing. If the agency denies the petition, it is required to promptly notify the petitioner of the reasons for denial. A declaratory ruling binds the agency and all parties to the proceedings on the statement of facts alleged, unless it is altered or set aside by a court. Declaratory rulings are subject to circuit court review in the same manner provided for review of administrative decisions.

SS SB 23/SS AB 23 would require DOR, upon petition by any interested person, or group or association of interested persons, to issue a declaratory ruling with respect to the applicability of any rule or statute enforced by the Department to any person, property, or state of facts. DOR would be authorized to issue a declaratory ruling on the facts contained in the petition. If the Department did not deny the petition or issue a declaratory ruling on the facts contained in the petition, the Department would be required to hold a hearing, and afford all interested parties an opportunity to participate in it. A declaratory ruling would bind the Department and all parties to the proceedings on the statement of facts contained in the ruling unless the ruling was: (a) altered or set aside by the Tax Appeals commission or a court; or (b) the applicable rule or statute was repealed or materially amended. A ruling, including the denial of the petition, would be subject to review by the Tax Appeals Commission. A petition filed under these provisions would have to conform to current law provisions regarding the form of and information included in petitions, and be filed with the Secretary of Revenue.

The Department would be required to deny the petition in writing, issue a notice that the Department would issue a declaratory ruling on the facts contained in the petition, or schedule the matter for hearing, no later than 30 days after the day that the Secretary of Revenue received a petition. If the Department provided notice that it would issue a declaratory ruling, it would have to be issued within 90 days after issuing the notice. The Department could deny the petition only if the petition failed to comply with current law requirements regarding form of, and information provided in the petition, or if DOR determined that the petition was frivolous, a justiciable controversy did not exist, the ruling would not provide guidance on matters of general applicability, or the ruling would substitute for other procedures available to the parties for resolution of the dispute. DOR would be required to promptly notify the person who filed the petition of its decision to deny a petition, and include the reasons for the denial in the notice. DOR could not deny a petition for lack of a justiciable controversy solely because the only parties to the matter were the petitioner and the Department.

In cases where DOR did not deny the petition for a declaratory ruling, or issue a notice that was going to issue a declaratory ruling based on the facts contained in the petition, the Department would be required to hold a hearing on whether the petitioner presented sufficient facts from which to issue a declaratory ruling. The hearing would be required within 180 days after the Secretary of Revenue received the petition. DOR, the petitioner, and other parties could take and preserve evidence prior to, and during the hearing, using the methods allowed for state agency hearings. If the parties agreed, DOR could rule on the petition based on facts stipulated by the parties.

Following the hearing, if DOR determined that it did not have sufficient facts to issue a declaratory ruling, the Department could deny the petition. If the Department determined that it did have sufficient facts to issue a declaratory ruling, it would be required to issue a ruling on the merits of the petition within 180 days after the determination. The deadline for issuing such a ruling could be extended by all parties. DOR could rule to deny the petition on the grounds that the petition was frivolous, a justiciable controversy did not exist, the ruling would not provide guidance on matters of general applicability, or that the ruling would substitute for other procedures available to the parties for resolution of the dispute.

Awarding Costs of Administrative hearings. Under current law, if at any time during an administrative proceeding, a hearing examiner determines that a hearing begun by a petitioner, or a claim or defense used by a party is frivolous, the hearing examiner is required to award to the successful party to the proceeding, the costs and reasonable attorney fees that are directly attributable to responding to the frivolous petition, claim, or defense. SS SB 23/SS AB 23 would extend this provision to Tax Appeals Commission hearings.

Class Action Court Proceedings. SS SB 23/SS AB 23 would prohibit class action lawsuits against the state or any other party, if the relief sought included tax refunds or damages associated with a tax administered by the state.

Effective Date and Initial Applicability. The bills would take effect on the first day of the third month beginning after publication.

The provision that modifies the authority to bring class action lawsuits would first apply to lawsuits that are begun on the effective date of the bill.

Provisions related to nonacquiescence in Tax Appeals Commission rulings and citing such rulings, reliance on published guidance, and awarding hearing costs would apply to determinations issued on or after the effective date of the bill, regardless of whether the amounts at issue related to transactions that occurred prior to the effective date.

Provisions related to determining negligence in filing returns and reports would apply to interest and penalties imposed on or after the effective date of the bill, regardless of whether the amounts at issue relate to transactions that occurred prior to the effective date.

The treatment of provisions related to reliance on past audits would first apply to audit determinations issued on January 1, 2014.

Provisions related to petition for declaratory rulings would first apply to petitions filed on the effective date of the bill.

FISCAL EFFECT

SS SB 23/SS AB 23 would modify a number of current law provisions that govern the Department of Revenue's audit and related activities. The fiscal effects included in this section are based on information provided by the Department of Revenue.

Reliance on Past Audits. SS SB 23/SS AB 23 provide that a taxpayer would not be liable for a determination asserted by DOR if: (a) the liability was related to the same tax issue for which a prior determination was asserted; (b) evidence indicates that a DOR employee involved in the prior determination identified or reviewed the same tax issue and the Department failed to adjust the taxpayer's treatment of the tax issue; and (c) the liability asserted by DOR was not asserted in the prior determination. This provision would first apply to determinations issued on January 1, 2014.

In 2007 this provision was estimated to reduce state tax revenues by $6.5 million annually. DOR indicates that this provision would have a substantially smaller, but unknown, fiscal effect that would fluctuate based on audit selection. Because the provision first applies to determinations in 2014, there would be no fiscal effect in the current biennium.

Class Action Court Proceedings. The bills would prohibit class action lawsuits against the state or other party, if the relief sought included tax refunds, or damages associated with a tax administered by the state. DOR indicates that such suits are rare, but the bill would eliminate the risk of potentially large judgments against the state.

Awarding Costs in Administrative Hearings. The bills would permit the Tax Appeals Commission to award the costs and reasonable attorney fees to the successful party to a proceeding that were attributable to responding to frivolous actions. The Department estimates that it could incur no costs, or costs of up to $200,000, if there were awards for major cases involving specialized attorneys.

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