September 8, 2003

TO: THE UTAH LEGISLATURE

Transmitted herewith is the public version of a limited official use report entitled, **Report on Tax Commissioner Offer in Compromise and Waiver Program Practices**. This special project was requested by Representative Peggy Wallace.

Please note that minor portions of this report have been blacked-out ("redacted") so that we can provide you with the maximum amount of public information and still comply with statutory provisions governing protected, confidential and private information.

Specifically, we redacted two portions of text on pages 3 and 6 in order to protect collections methodology under the Government Records Access and Management Act (GRAMA), as provided in ***Utah Code*** 63-2-304(14): "the following records are protected if properly classified by a governmental entity: . . . records and audit workpapers that identify audit, collection, and operational procedures and methods used by the State Tax Commission, if disclosure would interfere with audits or collections . . . ." We also redacted an additional portion of text on page 5 which contained information gained from returns filed with the Tax Commission. This information has been classified as "Confidential" under ***Utah Code*** 59-1-403(1) and also classified as "Private" under ***Utah Code*** 63-2-302.

As with all other audits, we will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in this report.

Sincerely,

Wayne L. Welsh
Auditor General

WLW:DRU/lm

September 8, 2003
ILR 2003-C

Representative Peggy Wallace
Utah House of Representatives
318 State Capitol Building
Salt Lake City, UT 84114

Subject: Public Version of a Limited Official Use Report on Tax Commissioner Offer in Compromise and Waiver Program Practices

Representative Wallace:

In accordance with your audit request, our office has conducted a limited review of the Utah State Tax Commission's offer in compromise (OIC) and waiver programs. Specifically, we were asked to review the offers in compromise and waivers of tax, penalty and interest approved by the Tax Commissioners.

Under the Utah State Tax Commission Management Plan, as set forth in the Administrative Rules governing the Tax Commission, the Tax Commissioners are required to review any "offer in compromise agreements that abate tax, penalty and interest over $10,000 as per the offer in compromise policy." In addition, the Tax Commissioners are also required to review any "waivers of penalty and interest in the amounts of $10,000 or more as per the waiver of penalty and interest policy." Therefore, since this audit focuses only on those OICs and waivers reviewed by the Tax Commissioners, we audited only those OICs and waivers requesting at least a $10,000 reduction. OIC and waiver requests which do not meet the $10,000 threshold are reviewed and either approved or denied at the Taxpayer Services Division level and were not included in this audit review. During our review we found:

1. No evidence of excessive OICs approved by Tax Commissioners.

2. Sampled waivers also showed no evidence of excessive approval.

3. In addition, we believe the Tax Commission follows a reasonable standard of criteria for applying offers in compromise and waivers.

No Evidence of Excessive OICs Approved by Tax Commissioners

In adopting the offer in compromise (OIC) program, the Utah State Tax Commission has established criteria to help evaluate each case under consideration. Based on that criteria, roughly in the last two years, the Tax Commissioners have denied more OICs than they have approved. Of the files we reviewed where a taxpayer applied for an OIC, we found no evidence of questionable or excessive liabilities compromised by the Tax Commissioners. Based on our judgment, it appears that the Tax Commissioners are approving or denying OICs with prudence and an even hand. Furthermore, we find no evidence in our OIC and waiver samples to support any allegations that some taxpayers are given preferential treatment by the Tax Commissioners.

Established Criteria Aids Tax Commissioners' Review

Each OIC file is considered on a case-by-case basis, based on the taxpayer's situation. However, preestablished criteria is considered and used for comparison in each case in order to create uniformity in approving or denying each case. The Tax Commission has defined an OIC as "the settlement of a tax liability for less than full payment." Through an OIC, the Tax Commission can abate tax, penalty, and interest.

According to policy, the OIC program strives to resolve cases based on doubt as to collectability, doubt as to liability, and the ability to pay the debt within a reasonable time frame. The Tax Commission may compromise a delinquency if the collection of the full amount would create an economic hardship or is detrimental to the concept of voluntary compliance. The program, as described in the OIC Procedures, is intended to "create an opportunity to resolve a liability 'today' as opposed to waiting for a later opportunity that may or may not happen." The Tax Commissioners believe that the aim of the OIC program is not to get the last dollar from the taxpayer. The program focuses on a compromised solution.

According to the OIC procedures, an OIC can be considered when, upon review of a taxpayer's assets, liabilities, income, and expenses, the liability cannot realistically be paid in the foreseeable future. The OIC procedures list guidelines which should govern the approval of an offer. Some of those items include the following:

- The taxpayer's earning capacity must be evaluated, reviewing the taxpayer's education, profession or trade, age, experience, etc.,
- The amount of cash on hand, including savings, and the cash value on a life insurance plan, as well as other liquid assets,
- Tangible personal property, such as trucks and automobiles, and
- Inventory and receivables, especially for an ongoing business.

The OIC program may be used for all tax types. For example, in the case of a business, OICs are generally used when a company is out-of-business and there are little, if any, assets available to recoup the tax, penalties, and interest owing.

[redacted]

Tax Commissioners Deny More OICs Than They Approve

Between fiscal years 2001 and 2002, the Tax Commissioners reviewed and either approved or denied 208 cases applying for the OIC program. As discussed initially in this report, the Tax Commissioners are only required to review OICs where the amount requesting to be compromised is at least $10,000.

The philosophy behind the OIC program is that an approved OIC represents potential revenue *today* compared to more improbable revenue at a later date. However, Figure 1 shows that Tax Commissioners are not simply making wholesale approvals of OICs. In our opinion, this implies that due judgement is being made to only accept those offers where compromised delinquencies could not have been otherwise pursued. In fact, the Tax Commissioners approved less than half of those cases requesting a compromise. Figure 1 shows that of the 208 OIC cases reviewed by the Tax Commissioners, 105 cases were denied and 103 were approved.

Figure 1. Tax Commissioners Denied Over Half of the Offers in Compromise Above the $10,000 Threshold. Fifty-four percent of delinquent tax, penalty and interest, reviewed by the Tax Commissioners in fiscal years 2001 and 2002 was denied for an OIC.

Total Cases Reviewed		Delinquent Tax	Delinquent Penalty & Interest	Total	Percentage
Approved:	103	$2,330,332	$2,969,004	$5,299,337	46%
Denied:	105	$3,057,923	$3,201,378	$6,259,301	54%
TOTAL:	**208**			**$11,558,638**	

Audit Sample Supports Tax Commissioners' Uniform Review of OICs

Applying the Tax Commission's policies and criteria for reviewing OICs led us to the same outcome as the Tax Commissioners on all of the cases we reviewed. We agree with all the Tax Commissioners' decisions that we reviewed. Despite the time restraints placed on a special project review and the length of the OIC files, we reviewed 32 of the 208 cases (15 percent) which came before the Tax Commissioners between fiscal years 2001 and 2002. We reviewed case files for consistency with policies and application to other cases. Figure 2 illustrates the common reasons for either approving or denying the sample cases.

Figure 2. Sample OIC Cases Reflect Tax Commissioner Consistency. We audited 14 approved cases and 18 denied cases which we believe reveal a consistent history of review from the Tax Commissioners.

Cases Reviewed	Outcome	Reason
5	Approved	Lack of assets to collect
1	Approved	No legal obligation to pay
5	Approved	Expired liens
1	Approved	Discharged through bankruptcy
2	Approved	Tax Commission error
7	Denied	History of non-compliance
11	Denied	Taxpayer able to make payments
Total: 32		

OIC Case Approvals Seem Fair and Consistent. One example of an OIC case approved was because of the lack of assets to collect from a taxpayer whose business went under, with the business owing taxes for only a few months. [redacted] The Tax Commissioners determined this to be a fair compromise and we agree because the taxpayer paid a significant portion of the debt. It seems counter-productive to force this taxpayer to pay the full sum since, at this point, there are no assets to borrow against or sell. Denying this compromise would likely create a severe financial hardship for the taxpayer.

OIC Case Denials Also Seem Fair and Consistent. We also found that the Tax Commissioners are consistent in denying OICs cases which involve a taxpayer with a history of non-compliance. Out of the 32 OIC cases reviewed, eight involved taxpayers with a history of non-compliance; seven of these cases were denied. We discussed with the Tax Commission chairperson the reasoning for approving the one OIC, which dated back to 1985. The commission chair said that the Tax Commissioners felt this file was not actively worked by the Tax Commission. She believed the Tax Commission had "dropped the ball" on this case. In addition, the taxpayer did pay 45 percent of the debt. We agree with the outcome of this case because the Tax Commission has no other collection options since the case was not worked [redacted].

A more common example of a denied OIC request usually involves a taxpayer who has the assets to pay the debt but claims he or she does not. Many times the taxpayer fails to list assets he or she owns on the financial statement. Although the Tax Commissioners' staff handling OICs and waivers is small, based on our observation and review, they seem to do a thorough asset search in order to make the determination if the taxpayer can actually pay the debt.

Sampled Waivers Also Show No Evidence of Excessive Approval

The waiver program is administered through different criteria than OICs; however, the criteria that governs the waiver program is equally well-established and outlined. The waiver program has been promulgated through statute. Similar to OICs, we found that since July 2002, the Tax Commissioners have approved less than half of the amount of total waivers requested. A sample of the waivers reviewed by the Tax Commissioners show no evidence of excessive or inappropriate approval.

Unlike the OIC program, the waiver program requires the taxpayer to pay the total tax due before requesting a waiver of penalties and/or interest. A common use of the waiver program is for a company that is still conducting business, still has assets, and penalties are accumulating periodically which the company would like waived.

The Waiver Program Is Defined by Statute

Utah Code 59-1-401(10) gives the Tax Commission statutory power, "upon making a record of its actions, and upon reasonable cause shown," to "waive, reduce or compromise any of the penalties or interest" assessed. The Tax Commission has defined reasonable cause as "a cause that arises despite the ordinary care of the taxpayer." Each case is reviewed on the reasonable cause standard. The Tax Commission allows appeal on a denied waiver decision, as set forth in the Administrative Procedures Act and Tax Commission Rules.

Some examples of when penalties and/or interest may be waived are:

- death or serious illness of the taxpayer or a member of the immediate family,
- unavoidable absence where the taxpayer solely responsible for the return was unavoidably absent from the state,

- destruction by a fire or natural disaster, destroying the taxpayer's records,
- incorrect written advice from the Tax Commission, unless the taxpayer has provided the Tax Commission with inaccurate information, or
- employee embezzlement, with certain levels of evidence from the affected taxpayer.

In reviewing a waiver case, the Tax Commissioners consider whether the penalty was assessed due to taxpayer negligence, intent or any other reason causing the penalty and/or interest to accrue. Based on the taxpayer's actions, if the penalty/interest accrued because of error, the Tax Commissioners may consider whether there was a reasonable, intentional error or negligent error. The Tax Commissioners also consider if the taxpayer has had a previous error of the same type in the last three years.

According to the Tax Commission's pamphlet on the waiver program, "a request for waiver of any penalties and/or interest will be considered when:

- the taxpayer provides a signed statement requesting a waiver,
- the total tax owed for the period(s) has been paid,
- the tax liability is from a filed return, not from estimated or non-filing amounts, and
- the petitioner has not previously received a waiver review for the same period(s).

The Tax Commission has stated that in order for interest to be waived "the taxpayer must prove that the Tax Commission contributed to the late filing and/or late payment through inappropriate information or action." Again, from our sample, we found no evidence to support allegations that waivers are excessive or inappropriate. Also from our sample, we found that waiving interest is much less common than waiving penalties.

Tax Commissioners Waive less than Half of the Total Amount Requested

As discussed earlier in this report, the Tax Commissioners are only required to review those cases requesting a waiver of penalty and/or interest $10,000 dollars or higher. From July 2002 to February 2003, due to the $10,000 minimum review criteria, the Tax Commissioners were only required to review 44 (1 percent) of the 3,318 cases which requested the waiver program during that time period. Figure 3 shows the results of the Tax Commissioners' waiver reviews by tax type.

Figure 3. Tax Commissioners Waived 44 Percent of the Total Delinquent Penalties and Interest. Of the 44 cases the Tax Commissioners were required to review from July 2002 through February 2003, they waived less than half of the requested sum.

Tax Type	Reviewed by Tax Commissioners	Amount Requested to be Waived	Amount Waived	Percent
Corporate Franchise	3	$ 613,494	$ 43,946	7%
Income	9	363,485	195,087	54
Mineral Production Withholding	1	11,191	0	0
Motor Fuel	1	17,822	8,508	48
Sales	19	411,992	288,348	70
Withholding	11	228,906	191,939	84
Total Cases Reviewed	**44**	**$1,646,890**	**$727,828**	
		Total Percent Waived of Requested	**44%**	

By waiving $727,828, the commissioners denied waiving $919,062 or 56 percent of the total amount requested for approval.

Sample Shows No Evidence of Excessive Waivers

Upon sampling a portion of the waiver case files reviewed by the Tax Commissioners, we also agree with all decisions reached. We believe that when the Tax Commissioners consider a waiver of penalty and/or interest, their policies are considered and applied equitably. As with OIC cases, waiver cases were also reviewed to find the Tax Commissioner's consistency in applying policies and previous case decisions. Because the waiver files are considerably smaller, we were able to review 45 percent of the waivers which came before the Tax Commissioners in fiscal year 2003.

Approved Waivers Seem Reasonable. A few examples of waivers approved by the Tax Commissioners, which we reviewed, include:

- A waiver request of a business owner who was notified late, by the Tax Commission, of changes in his filing requirements.
- A waiver request by a taxpayer in good standing, filing timely returns, who paid the requisite taxes, just filed the returns late. The taxpayer claims to have mailed the returns on time but could not locate proof of mailing. This taxpayer usually wires the returns or sends them by courier but has also used regular mail in the past. In granting the waiver, the Tax Commissioners considered the taxpayer's good standing and the fact that the Tax Commission had the use of the money.
- An approved waiver of penalties for a taxpayer who was in the process of changing banks when his payment was lost due to a computer error. The taxpayer was in good standing and promptly paid the tax.

Example Illustrates Reasonableness of Waiver Denials. An example of a denied waiver request includes a taxpayer requesting several hundreds of thousands of dollars of penalty waivers. The taxpayer claims he relied on tax advisors and an ex-employee to file returns. The taxpayer claims he is inexperienced and his employees advised him incorrectly, thus causing the problems. Finally, this taxpayer has a poor compliance record. The Tax Commissioners denied this request due to a lack of reasonable cause; ultimately, it is the taxpayer's responsibility to timely file the appropriate returns and submit payment if applicable.

According to the Tax Commission, even reliance on a competent tax advisor who provides incorrect advice is not necessarily reasonable cause to permit a waiver, if the taxpayer did not demonstrate he or she exercised "ordinary business care and prudence based on his own knowledge in determining whether to seek further advice." Therefore, it is reasonable to understand why reliance on one's employees does not constitute reasonable cause. We agree with the outcomes of both the approved cases and the one denied case discussed above.

Tax Commissioners Follow Reasonable Policies

Overall, we believe the Tax Commission's OIC and waiver policies are reasonable. Since we found no evidence of excessive compromises or waivers from our sample, we believe the Tax Commissioners have a reasonable system of review. The Tax Commissioners' philosophy is to allow taxpayers a "fresh start." They believe that if given a second chance taxpayers usually become compliant in the long-term.

However, reasonableness of the policies is relative to how aggressively Utah wants to enforce the system. For example, Oregon seems to take a more stringent approach than Utah. According to the OIC program in Oregon, each taxpayer is only allowed one OIC within a three-year period of time. And if, within three years of compromise, the taxpayer fails to either file a return or misses a payment, the Oregon Department of Revenue has the option to reinstate, to the full amount, the liabilities previously compromised. Utah does not have such an explicit policy, and according to one tax official, nor do they have the technology to enforce this level of compliance. Currently, the commissioners and their staff are working to tighten-up OIC and waiver policies with an aim to make the program as uniform as possible. Still, compared to four other states, Utah has the most stringent dollar-review criteria in OICs and waivers.

Other States Offer Similar OIC/Waiver Programs

We contacted four other states and found that they all offer both an OIC and a waiver program, although the programs may be known by another name in those states. There are many similarities between the five states' programs (including Utah), and also some differences.

All five states' programs work in a similar way. Each applies the programs on a case-by-case basis. When a taxpayer applies for either an OIC or a waiver, the taxpayer must submit several documents to support the request. Some of these documents may include a letter of explanation formally requesting the particular program, financial statements, bank statements, detailed asset and liability information, and so forth. In addition, the other states also have a "reasonable cause" or "good and sufficient cause" level of review. An official from one state commented that their focus is on what's best for the state. For example, if the cost of collecting the delinquent funds exceeds those fund's value, collection efforts are futile. We have been told that Utah also follows this ideology.

However, we found that the Tax Commission has the most stringent dollar-level of review among the five states. In Utah, all four Tax Commissioners must review and either approve or deny any OICs or waivers when the compromise or waiver is valued at $10,000 or higher. In other states the highest level of review (comparable to a board of commissioners) is set well above Utah's dollar level of $10,000. Figure 4 shows each of the five states' highest level of review for a compromise or waiver.

Figure 4. Utah's Highest Level of Review is Required at the Lowest Dollar Amount. The four other states contacted require much higher minimum dollar amount thresholds before their highest level of review is required to approve or deny the compromise or waiver.

State	Dollar Amount	Level of Review
Arizona	$100,000 or Higher	Attorney General
Idaho	Greater than $50,000	All Four Commissioners
Oregon	Greater than $50,000	Division Administrator
Utah	**$10,000 or Higher**	**All Four Tax Commissioners**
Washington	Greater than $50,000	Deputy Director

The Internal Revenue Service also has an Offer in Compromise program. The IRS uses standards very similar to Utah's standards. For example, an OIC at the federal level may be considered in these circumstances:

- doubt as to liability,
- doubt as to collectability, or
- exceptional circumstances exist, such as economic hardship or assessing the tax would be unfair and inequitable.

As mentioned earlier, Utah also considers OICs under these situations. Utah's OIC and waiver policies and practices mirror those of the federal government as well as several surrounding states.

In summary, we hope this report addresses the specific concerns you had regarding the Tax Commissioners' assessment of cases in the offer in compromise and waiver programs. We look forward to further assisting the Legislature with any follow-up questions. If you have further questions concerning this report, please call Audit Supervisor Darin Underwood at 538-1033 extension 121.

Sincerely,

Wayne L. Welsh, CPA
Auditor General

WLW:DRU/lm