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How The District Of Columbia Might Better Manage Its Tax Compliance Program

The District should have a system for identifying and analyzing the reasons that individuals and businesses are not voluntarily complying with its tax laws. Such a system would allow the District to better communicate tax law requirements to the public and improve assessment and enforcement procedures.

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MARCH 12, 1976

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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

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To the Mayor and Council
of the District of Columbia

CN600052

This report describes the District's program for encouraging individuals and businesses to comply voluntarily with District tax laws. An information system is needed as a better basis for focusing management's attention on problem areas.

Section 736(b)(3) of the District of Columbia Self-Government and Governmental Reorganization Act (Public Law 93-198, 87 Stat. 774), approved December 24, 1973, requires the Mayor, within 90 days after receiving a GAO audit report, to state in writing to the District Council what has been done to comply with our recommendations and send a copy of the statement to the Congress. Section 442(a)(5) of the same act requires the Mayor to report, in the District of Columbia's annual budget request to the Congress, on the status of efforts to comply with such recommendations.

We are sending copies to interested congressional committees and the Director, Office of Management and Budget, as well as to the Directors, Office of Budget and Management Systems, Department of Finance and Revenue, and Office of Municipal Planning.

Victor L. Lowe

Victor L. Lowe
Director

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ABBREVIATIONS

DFR Department of Finance and Revenue
IRS Internal Revenue Service
OMAI Office of Municipal Audit and Inspection
TALD Tax Audit and Liability Division
TCRD Tax Compliance and Registration Division

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D I G E S T

Self-assessment and voluntary payment of taxes are fundamental to a successful District tax program. The District collected about \$396 million in fiscal year 1975 through taxpayers' voluntary self-assessments.

The District has encouraged voluntary compliance with tax laws by an active program of taxpayer assistance and enforcement: identification of and followup on nonfilers, audit of tax returns, and collection of delinquent taxes. However, more could be done. Systematic analysis and evaluation of the program should help the District to achieve greater voluntary taxpayer compliance and to receive revenue that otherwise would require enforcement effort.

The District must find out why people (1) need help with their tax returns, (2) do not file returns or pay their taxes, and (3) make mistakes in preparing their returns. With such insights, the District should know more precisely when it needs to (1) better inform the public and (2) improve assessment and enforcement procedures. The District needs to establish a system for analyzing the voluntary taxpayer-compliance program and provide for obtaining the information for such analysis.

The District's Department of Finance and Revenue agreed that more emphasis on program analysis and evaluation was needed. As a result, internal evaluation of department programs was transferred to the Office of the Director of Finance and Revenue and the information and resource requirements for analyzing and evaluating voluntary taxpayer compliance are being studied. Mayor Washington said that he will support the Department's efforts in this area.

The Department of Finance and Revenue recognizes that administration of the District's self-assessed taxes might be improved by:

DLG 00788

GA 000180

--Establishing computerized master (historical) tax files.

--Improving coordination of compliance activities for the personal property tax and other business taxes.

--Closer monitoring of tax exemptions.

The Mayor indicated that the District will consider the improvements needed in these areas.

CHAPTER 1

INTRODUCTION

In fiscal year 1975, the District of Columbia collected about \$396 million from self-assessed taxes--those for which taxpayers filed returns and established the amounts due. Self-assessed taxes include sales and gross receipts, income (individual, corporation franchise, and unincorporated business franchise), and inheritance and estate taxes.

Tax administration is based on the premise that individuals and businesses will (1) voluntarily follow the laws, regulations, and related assessment instructions, (2) file proper tax returns, and (3) pay taxes due.

To encourage individuals and businesses to pay their taxes, the District, like the Federal and State governments, (1) communicates its tax law requirements to taxpayers, (2) helps them understand the rules, (3) audits tax returns, (4) identifies and follows up on nonfilers, and (5) collects delinquent taxes.

The Department of Finance and Revenue (DFR) administers the tax laws. DFR's authorized positions and fund allotments for fiscal year 1975 were as follows:

<u>Category</u>	<u>Positions</u>	<u>Allotment</u>
Administration	22	\$ 510,800
Programs and data systems	67	1,127,400
Assessment administration	147	2,178,500
Tax administration	195	2,973,300
Treasury	<u>100</u>	<u>1,513,700</u>
Total	<u>531</u>	<u>\$8,303,700</u>

DFR's Office of Tax Administration is principally responsible for assuring compliance with the tax laws. The Tax Compliance and Registration Division (TCRD) informs and assists taxpayers and discovers and follows up on nonfilers. The Tax Audit and Liability Division (TALD) audits tax returns and supplements TCRD's information and assistance effort.

Until fiscal year 1975, the District Treasury Office enforced payment of delinquent taxes (excluding real estate).

The Office of Tax Administration now does this. Prosecution of tax delinquents is handled by Corporation Counsel.

In fiscal year 1975, internal evaluation of the tax programs was transferred from the Office of Program and Data Systems to the Director of DFR.

SCOPE OF REVIEW

We examined the District's means of promoting self-assessment and voluntary payment of taxes and discussed compliance programs with Internal Revenue Service (IRS) tax officials from several States.

We reviewed the District's policies, procedures, regulations, and available statistics on the administration of self-assessed taxes. The District performed certain compliance tests for us.

Our review was limited, since we were denied access to tax returns and related tax administration records because of D.C. Code 47-1564 (income and franchise taxes) and 47-2615 (sales tax). These statutes prohibit the District from divulging the data contained in a specific tax return or related records, except to an official of the District with a right to such data or the proper officer of the United States or any State.

The District's Corporation Counsel has ruled that the "proper officer of the United States" referred to in the code is one that administers Federal tax laws--the IRS Commissioner or his authorized representatives.

Under this ruling we could not verify the District's information or review any compliance activities involving detailed tax information.

CHAPTER 2

NEED FOR SYSTEMATIC ANALYSIS AND EVALUATION OF COMPLIANCE PROGRAM RESULTS

The District has an active program for administering self-assessed taxes; however, more could be done to improve voluntary taxpayer compliance. DFR had not established a system to analyze the voluntary taxpayer compliance program and lacked adequate information for such analysis. Therefore, DFR did not have data on the reasons individuals and businesses are not voluntarily complying with the tax laws sufficient to identify problems needing attention.

INFORMATION NOT AVAILABLE FOR EFFECTIVE ANALYSIS AND EVALUATION

The following sections discuss the data needed for effective analysis and evaluation of taxpayer assistance, identification of and followup on nonfilers, audit of tax returns, and collection of delinquent taxes.

Taxpayer assistance

Voluntary compliance with self-assessed taxes requires adequate information. In addition to routinely distributing tax forms and instructions for completing them, DFR's information program in fiscal year 1974 consisted of

- preparing and distributing information which communications and news media could use to publicize the individual income tax and the availability of tax assistance from the District government,
- providing instructions and training to selected government and industry employees to enable them to help their fellow employees prepare tax returns,
- participating in public affairs broadcasts to present individual income tax information,
- discussing tax matters before trade associations and professional groups, and
- ruling on technical interpretations of tax laws.

TCRD, aided periodically by TALD, provides additional assistance and information requested by taxpayers. In fiscal year 1974, TCRD received about 136,000 requests for

assistance and information by telephone calls, personal visits, and correspondence. About 15 staff-years were used in answering these requests.

Requests for individual income tax assistance and information accounted for more than 100,000 of these contacts--about 1 contact for every 3 individual income tax returns filed. The remainder were from businesses. Data on these taxpayers' requests for help was not documented to provide a basis for meaningful analysis of how many taxpayers of what status needed what kinds of help.

During the filing period for tax year 1974, IRS had a program to accumulate data on telephone assistance requests to identify the 25 questions most frequently asked by taxpayers. IRS believed this information would provide a basis for improving its taxpayer assistance efforts, which, in turn, should enhance voluntary compliance by taxpayers. This is an example of the data collection needed in the District's taxpayer assistance program.

A good tax information program also needs data from the District's other compliance activities. (See p. 17.) For example, audits of tax returns could reveal specific needs for clarified instructions or general publicity. Therefore, these activities must be systematically analyzed and evaluated before an effective information program to improve voluntary compliance is possible.

Identification of and followup on nonfilers

TCRD identifies and follows up on individuals and businesses that do not file tax returns. About 33 staff-years were used in fiscal year 1974 to followup on nonfilers; 8 of these dealt with individual income tax and 25 with business taxes.

These are the results of TCRD's followup for fiscal year 1974:

<u>Type of case</u>	<u>Cases followed up</u>	<u>Total assessed</u>
		(millions)
Individuals	8,875	\$ 2.3
Businesses	<u>a/41,923</u>	<u>12.8</u>
Total	<u>50,798</u>	<u>\$15.1</u>

a/This is not the number of businesses involved. Businesses are required to file returns and pay taxes monthly, quarterly, or annually depending on the amount of tax owed. A delinquency occurs when a required return is not received on time. It would be possible for a large firm which was required to file monthly returns to be delinquent several times during the year.

Individual income tax

Recommendations to increase the effectiveness of the District's program to identify and follow up on individual income tax nonfilers were included in our report to the Congress entitled "What is Being Done About Individuals Who Fail to File a District Income Tax Return?" (GGD-75-8, Mar. 20, 1975). In this report, we took the position that all identified potential nonfilers must be contacted and made to pay any income taxes due. Such action should enhance future voluntary compliance with income tax filing and income reporting requirements.

The causes for nonfiling must be identified and analyzed to find out how to reduce future nonfilings. DFR did not have quantitative data on the reasons individuals failed to file returns; therefore, DFR management did not have adequate information to address the nonfiling problem in the most effective manner.

At our request, TCRD officials experienced with following up on nonfilers listed the reasons for nonfiling in what they believed to be the order of frequency, from most to least frequent, as follows. The nonfiler:

1. Worked outside the District (usually Maryland or Virginia) and the employer did not withhold District income tax; the nonfiler did not understand procedures requiring the filing of a declaration.
2. Did not realize a tax return (D-40) should have been filed at the end of the year, because District tax was withheld or a declaration was filed.
3. Was domiciled (maintaining permanent legal residence) in the District but living outside of the District and did not understand the meaning of the term domicile.
4. Did not know there was a District income tax.
5. Was employed by the U.S. legislative branch and thus thought he or she was exempt.
6. Was employed as a Presidential appointee and thought he or she was exempt, but was liable because of domicile in the District or lack of Senate confirmation.

7. Entered military service from the District and thought he or she was exempted by the Soldiers' and Sailors' Civil Relief Act.
8. Thought the return had been filed by an accountant or attorney.
9. Believed retirement pay or disability pay was exempt.
10. Was the spouse of a Presidential appointee or of an elected officer's employer and believed himself or herself to also be exempt.

The list represents the kind of information that should be systematically derived from the results of the followups on nonfilers and then analyzed and evaluated to develop procedures to reduce nonfiling.

Business taxes

The business master index file is used by DFR to discover whether businesses complied with tax filing requirements and to register all businesses in the District for tax purposes. Businesses are indexed through DFR registration procedures. In fiscal year 1974, about 35,000 businesses were registered.

According to DFR procedures, businesses are told when registering of taxes owed and tax filing requirements. Tax returns filed are matched against registration records, and registered businesses that have not filed returns or paid taxes due are followed up on. To facilitate this process, DFR is computerizing its master index file.

DFR relies on information from inside and outside the District government to identify firms doing business in the District without having registered for sales, withholding, or franchise taxes. The principal sources of such information are:

1. The Department of Economic Development for occupancy permits issued to new businesses.
2. The Department of General Services for contracts awarded for building demolition and construction.
3. The Armory Board for scheduled events to be held in the D.C. Armory.
4. Dodge Reports monthly publications for construction contracts awarded in the District.

5. Recorder of Deeds for firms incorporating in the District.
6. The yellow pages of the telephone directory.

In fiscal year 1974, TCRD discovered 559 businesses that were not registered with the District for taxes. These delinquencies are included in the 41,923 cases shown on page 4.

According to DFR's records, considerable backlogs exist in following up on business tax delinquents. The backlogs as of June 30 of fiscal years 1974 and 1975 were 4,053 and 11,440 cases, respectively. DFR had projected that the rate of tax delinquency and delinquent case backlogs would increase, due in part to

- increased tax rates inducing the chronic delinquent to avoid filing and/or paying until compelled to do so and
- staffing limitations making it difficult to deal with increasing delinquents.

DFR did not have information compiled on the reasons businesses became delinquent. Information on the problems businesses have in complying with filing requirements should help DFR find ways to improve the situation.

Audit of tax returns

TALD audits self-assessments by individuals and businesses. In a tax program which relies essentially on voluntary compliance with tax laws, auditing of tax returns can affect taxpayers' preparation of returns in two ways: helping to deter willful inclusion of erroneous information on tax returns and providing tax administrators with useful data on taxpayers' problems with understanding instructions and preparing their returns.

TALD's audits attempt to achieve equity, broad coverage of all tax areas, and the greatest additional revenue. Returns audited, resources applied, and added revenue over the three fiscal years ended June 30, 1974, are shown below for each type of tax.

	<u>FY 1972</u>	<u>FY 1973</u>	<u>FY 1974</u>
Individual income:			
Audited returns	11,322	12,223	15,214
Audit revenue	\$1,144,214	\$1,226,617	\$1,741,028
Audit hours	31,086	30,689	31,747
Fiduciary:			
Audited returns	98	63	143
Audit revenue	\$ 4,860	\$ 22,806	\$ 5,579
Audit hours	140	79	231
Withholding:			
Audited returns	440	417	477
Audit revenue	\$ 82,448	\$ 20,031	\$ 28,554
Audit hours	949	840	938
Corporation:			
Audited returns	826	1,087	868
Audit revenue	\$ 198,808	\$ 614,910	\$ 684,647
Audit hours	3,192	4,086	3,694
Unincorporated business:			
Audited returns	353	410	347
Audit revenue	\$ 36,486	\$ 77,844	\$ 133,882
Audit hours	1,111	1,307	1,358
Sales and use:			
Audited returns	437	340	438
Audit revenue	\$ 836,298	\$ 945,276	\$1,175,892
Audit hours	21,353	15,268	19,005
Motor fuel:			
Audited returns	1	1	1
Audit revenue	\$ 2,022	\$ -	\$ 19,696
Audit hours	83	74	134
Alcoholic beverage:			
Audited returns	60	52	58
Audit revenue	\$ 354	\$ -	\$ 1,970
Audit hours	2,273	1,558	1,927
Cigarette:			
Audited returns	4	4	5
Audit revenue	\$ 4,304	\$ 3,338	\$ 1,094
Audit hours	826	504	846
Inheritance and estate:			
Audited returns	3,219	2,979	2,980
Audit revenue	\$2,750,143	\$1,635,154	\$1,468,930
Audit hours	7,165	6,818	7,079

Total:				
Audited returns	16,760	17,576	20,533	
Audit revenue	\$5,059,937	\$4,545,976	\$5,261,272	
Audit hours	68,178	61,223	66,959	

The preceding schedule of general audit statistics is not detailed enough for meaningful evaluation, but it raises important questions which managers should answer by collecting more details. For example, over the 3-year period shown, audit revenue from individual income, corporation, and unincorporated business taxes steadily increased without a large increase in audit hours applied. The question posed to the manager is: "Why?" One possible explanation might be that inadequate steps were taken to correct the causes of audit findings in 1972 and/or 1973, and they were recurring.

DFR had no procedures for compiling audit results in the detail required to effectively evaluate findings. For example, one problem found by audit personnel in individual income tax returns involved differences in certain provisions of District and Federal income tax laws which often caused individuals to follow Federal rules instead of the District's. DFR had compiled no data on such erroneous reporting, such as items for which Federal rules were most often followed. Such data could help to determine corrective action needed and subsequently to measure the effect of that action.

Also, DFR uses various criteria for selecting returns to be audited. Data on results produced using each of these criteria was not available. Such information could help DFR evaluate the criteria and insure that auditing is increasingly directed toward obtaining voluntary taxpayer compliance and concentrating on areas of highest revenue productivity.

Because of our suggestions, DFR said it is now collecting data on audit results in more detail.

Collection of delinquent taxes

The collection of unpaid taxes is the ultimate enforcement action taken to equitably administer the District's tax system. It is the "teeth" of the system.

The Delinquent Collections Division collects all delinquent taxes except real estate. DFR can refer cases to the Corporation Counsel for prosecution when it believes such action is warranted. In fiscal year 1974, DFR spent about 31 staff-years to enforce collection of District taxes. Corporation Counsel assigned three attorneys to prosecute tax delinquents.

The following schedules show the delinquent collection actions completed during fiscal years 1972, 1973, and 1974, and the delinquent tax accounts receivable at the end of each year.

Delinquent Collections Actions Completed

Action	Fiscal year					
	1972		1973		1974	
	Number	Amount	Number	Amount	Number	Amount
Collected by DFR (note a)	13,654	\$4,842,279	18,060	\$5,753,783	21,136	\$6,618,851
Written off (note b)	5,976	623,936	8,147	816,774	7,542	795,797
Collected from prose- cutions (note c)	302	613,264	191	963,083	90	848,431

a/Included in DFR collections are delinquent taxes collected by the billings process without revenue officer action. Before referring delinquencies to revenue officers, the District will bill individuals twice and businesses once. The amounts of collections resulting from these billings were not available separately from DFR.

b/Accounts are written off after a determination by the District that further administrative or legal effort to collect taxes owed would not be productive. Delinquent taxpayers are not forgiven their tax debts, however.

c/Collections from criminal proceedings only. Collections from civil proceedings were not available.

Delinquent Tax Accounts Receivable

Tax	June 30, 1972		June 30, 1973		June 30, 1974	
	Number	Amount	Number	Amount	Number	Amount
Individual	39,569	\$3,808,097	44,955	\$4,529,447	42,510	\$5,989,018
Personal property	3,307	854,070	1,782	589,455	2,072	570,020
Sales	5,634	1,910,348	8,388	2,618,550	8,084	3,075,882
Employee withholding	3,324	672,749	4,132	889,049	4,810	1,277,833
Unincorporated	1,149	190,670	1,396	246,709	2,667	300,833
Corporation	956	304,575	1,276	382,590	2,515	520,807
Inheritance	857	1,599,910	994	1,219,577	1,002	1,915,131
Estate	22	376,843	17	162,358	8	148,807
Recordation	3	3,198	10	9,996	21	15,181
Others	<u>32</u>	<u>3,573</u>	<u>1</u>	<u>123</u>	<u>1</u>	<u>123</u>
Total	<u>54,853</u>	<u>\$9,724,033</u>	<u>62,951</u>	<u>\$10,647,854</u>	<u>63,690</u>	<u>\$13,813,635</u>

Note: Comparison of the above yearend balances with collections shown on the preceding page would be misleading because balances include penalties and interest computed to the date the delinquencies were established, whereas collections included penalties and interest to dates of collection.

When delinquent tax accounts are referred to revenue officers, their actions include: the use of dunning notices; telephone or field contacts with the delinquents; legal attachment of salaries, wages, bank accounts, and property; and referral to Corporation Counsel for prosecution. At his discretion, a revenue officer may take these actions successively or selectively, depending on his evaluation of the individual's or business' tax paying record.

The principal problem indicated by our review of delinquent tax collection activity is the backlog of cases. The collection effort is relatively successful once undertaken; for every dollar of delinquent tax written off in fiscal year 1974, \$9 were collected. Earlier contact could result in fewer writeoffs and prompter collection of taxes. Many writeoffs occur because by the time revenue officers initiate action the delinquent cannot be located or has no remaining assets.

Actions have been taken recently which should help to collect delinquent taxes, reduce backlogs of cases, and accelerate the collection process.

In April 1974, the Office of Municipal Audit and Inspection (OMAI) reported to the Mayor that for tax year 1972 about \$1.1 million in income tax was refunded to individuals who owed the District \$810,000 in taxes for prior years. Subsequently, DFR established a program to offset taxes owed by individuals against any refunds they claimed. In fiscal year 1974, \$768,000 was collected on 8,453 delinquent cases as a result of this program.

We also noted that, according to DFR procedures, when TCRD revenue officers who identify and follow up on nonfilers could not collect taxes, they turned cases over for enforcement to revenue officers in the Delinquent Collections Division, which was then part of the Treasury Office. This duplicative handling of cases by revenue officers unnecessarily delayed the enforcement effort. We suggested that once a nonfiling case was assigned to a revenue officer for followup, that officer should take all enforcement steps necessary to collect the tax due.

In December 1974, DFR transferred the Delinquent Collections Division from the District Treasury to the Office of Tax Administration. This was done to better coordinate the delinquent discovery and collections activities until DFR can fully review the feasibility of combining the enforcement activities of all revenue officers.

Greater efficiency of delinquent tax collection may be possible, but detailed data on these efforts--e.g., results of steps taken and measurement of particular collections problems--is needed to adequately evaluate how improvements can be made.

SYSTEM FOR ANALYZING
COMPLIANCE PROGRAM NOT ESTABLISHED

In fiscal year 1969, a program and evaluation staff was established by DFR and placed under the Associate Director for Program and Data Systems. In fiscal year 1974, the staff assigned consisted of three management analysts, a management analyst trainee, and a forms technician.

Program evaluation was inherent in the development, coordination, and administration of the Department's program planning and reporting system. DFR stated the primary purposes of the system as follows:

- To provide a systematic and uniform approach to planning and coordinating related Department activities.
- To more accurately estimate and project program requirements.
- To allocate resources.
- To inform the Director of program plans, progress, and problems.

Program evaluation corresponds to the last of these purposes, and when performed effectively it would provide information needed to accomplish the first three purposes.

To increase voluntary taxpayer compliance with self-assessed taxes, the reporting system should have been informing top management of progress made and problems encountered. It was not doing so because DFR had not established a system to analyze program results.

DFR officials said that systematic analysis of compliance activities had not been established because adequate resources were unavailable. The evaluation staff that was available concerned itself largely with other aspects of the reporting system--for example, developing periodic reports.

A factor contributing to the lack of emphasis on analysis and evaluation of the compliance program could have been the assignment of the evaluation staff to the Office of Programs and Data Systems, which is concerned with providing services to operating groups. With the thorough support of top management, program analysis and evaluation can function in any part of an organization, but it is most successful when--as is the case with internal audit groups--it is placed in an organization where its independence from operations is greater.

The Director, DFR, accepted our suggestion that program evaluation be moved to his office and, in December 1974, issued a departmental reorganization order to accomplish the transfer. The Director informed us that DFR was reviewing the existing management information system, evaluating existing data and the need for new data, and deciding whether management would need additional resources to improve information to use in planning, managing, and evaluating the program.

The District's internal auditors also should give more attention to reviewing tax administration. OMAI's audits of DFR activities have been principally in traditional internal audit areas, such as reviewing controls over cash receipts and disbursements. While these audits are necessary, OMAI should increase the scope of its work in DFR to include regularly scheduled broad reviews of tax administration. The Director of OMAI informed us that he will include such reviews in his future plans.

The newly established District of Columbia Auditor can provide additional audit coverage of tax administration. Since his reports can be made public, they could be an important source of information on the administration of District taxes. The District of Columbia Auditor should consider the adequacy of work done by OMAI when setting the scope of his reviews.

CONCLUSIONS

The concepts of self-assessment and voluntary payment of taxes are fundamental to a successful District tax program. The District collected about \$396 million in fiscal year 1975 from self-assessed taxes. The voluntary compliance with tax laws achieved in the District has been promoted by an active program of taxpayer assistance, identification of and follow-up on nonfilers, audit of tax returns, and collection of delinquent taxes. However, more could be done.

Systematic analysis and evaluation of the program could enable the District to achieve even greater taxpayer compliance with self-assessment rules, resulting in additional tax revenues. DFR had not established a system to analyze the compliance program, and inadequate information was compiled for such analysis.

DFR has recognized that it should place more emphasis on program evaluations. Program evaluation was transferred to the office of the Director of Finance and Revenue, which is studying what information and resources are needed for effective analysis and evaluation of the compliance program. This is the necessary first step to establishing a management information system that will enable DFR to analyze and evaluate the program from year to year.

RECOMMENDATIONS

{ The Mayor should:

- Insure that DFR (1) completes its review of the information and resource requirements for systematic analysis and evaluation of the tax compliance program as

soon as possible and (2) takes appropriate action to establish a management information system that will best serve the Department in planning its compliance activities.

--Provide the necessary resources to support DFR's efforts to improve the voluntary taxpayer compliance program.) Such efforts can help insure maximum revenue for District services and equitable distribution of the tax burden among District residents.

MAYOR'S COMMENTS

The Mayor said that although accumulating additional detailed statistics will take time away from revenue-collecting staff, additional useful knowledge about taxpayer compliance problems might result. He said that projects have already been initiated to accumulate more detailed statistics on tax audits and on the questions most frequently asked by taxpayers, and other projects are planned by DFR.

The Mayor said the District government will support the Department of Finance and Revenue's programs to improve voluntary compliance with tax laws.

We hope DFR can devise ways to develop the data it needs without placing undue administrative demands on personnel such as revenue officers engaged in compliance activities. Every possibility for using computers and/or support personnel for this task should be considered.

The measure of success in a self-assessment tax system is the extent of voluntary participation obtained from the taxpaying public. All tax compliance activities have as their objective increased voluntary taxpayer participation. An individual activity, such as following up on nonfilers, could be producing revenue year after year, but if it does not adequately inform management on program results, improving the program becomes difficult.

In summary, program analysis and evaluation is not an option of management; it is necessary to help DFR apply resources most effectively to further voluntary compliance with tax laws.

CHAPTER 3

SUGGESTIONS FOR IMPROVING TAX ADMINISTRATION

We noted some other areas in which the District's administration of self-assessed taxes could be improved. DFR officials recognized the need for the improvements and said that for most of them DFR had insufficient resources to further develop their potential.

ESTABLISHING COMPUTERIZED MASTER TAX FILES

The compliance program for self-assessed taxes could benefit if DFR established computerized master (historical) tax files on its taxpayers. A master file is a composite record of information, obtained from tax returns filed over the years by a taxpayer, including the amounts of any unpaid taxes.

The most widely known master tax files are at IRS. All tax data and related information pertaining to individual and business taxpayers are placed in the files, which thus contain a continuously updated record of each taxpayer's account. All settlements with taxpayers are made by computer processing of the master file accounts. The data is used for accounting records and for issuing refund checks, bills, or notices; answering inquiries; classifying returns for audit; preparing reports; and other IRS processing and enforcement activities.

As mentioned on page 6, DFR is computerizing its master files for businesses. This project has been in process for several years and progress is slow. DFR officials said that resources have not been available to speed its completion. In our opinion, this project deserves more emphasis.

The District should benefit from similar files for individual income taxes. With such a file, for example, DFR's recent program of subtracting delinquent taxes from refund claims (see page 12) could be accomplished routinely as returns are processed, rather than by specially matching refund claims against accounts receivable. The IRS master file system can also subtract business taxes due from persons who claim refunds on their individual income tax returns.

Other benefits that the District would derive from computerized master files for individual income taxes include a current tax return mailout listing and more convenient retrieval of information needed for audit and other compliance actions.

Maryland has had a computerized master file system for its individual income tax for several years, and Maryland tax officials said that the system's cost has been more than compensated for by improved tax administration. In choosing such a system, the District would have to study the cost-benefit relationships for its own operation.

Mayor's comments

"We are in agreement with your general observations on this subject area. As you know, we have developed consistent with available resources limited capacity in the business tax area. Furthermore, the fiscal year 1976 budget submitted to the Congress contains a request for funds to initiate a study and analysis of further needed improvements in the Department's computer utilization."

COORDINATING COMPLIANCE ACTIVITIES
FOR PERSONAL PROPERTY TAX
AND OTHER BUSINESS TAXES

DFR maintains a separate index file of businesses on compliance with the personal property tax. This tax is levied only on business property. Each year businesses file returns and declare the amounts of their personal property. DFR makes tax assessments on the basis of these declarations. The personal property tax is administered by DFR's Assessment Administration, the same office which administers the real property tax.

The index for the personal property tax, arranged by street address, accounts for every business address in the District. The primary source of information used to keep the index current is the Haines telephone directory. 1/

From the personal property tax index file and the Haines directory, we selected 116 businesses and, with the help of DFR personnel, ascertained if these firms were registered for applicable sales, withholding, and franchise taxes. The results of our test were:

1/Haines and Company, Inc., distributes the "Criss-Cross Directory" for Washington and its suburbs and for major cities coast to coast. The directory is indexed by street address and by phone number. Business listings are identified by asterisks.

	<u>Number</u>	<u>Percentage of total</u>
Registered for all applicable taxes	100	86
Unregistered for one or more taxes	13	11
Claimed exemption from franchise tax but had no application on file	<u>3</u>	<u>3</u>
Total	<u>116</u>	<u>100</u>

Of the 13 businesses which were not registered for one or more taxes:

- None had paid the taxes in question.
- 9 had moved from the addresses shown in the personal property tax records and could not be located.
- Three were unincorporated businesses and claimed they did not gross \$5,000 (minimum for filing).
- 1 appeared liable for tax and was so advised.

Personal property tax records indicated that most of the 13 businesses were small firms which had been in operation from 3 to 8 years. During this time, most had paid personal property tax, but no other taxes, to the District.

The procedures for identifying new businesses and obtaining their compliance with personal property tax did not include taking steps to make sure that the businesses also registered for other taxes. Similarly, businesses that registered for sales, withholding, or franchise taxes were not made specifically aware of personal property tax requirements, because the registration form does not include personal property information. Better coordinating personal property tax and other business tax collection could improve the overall compliance program for businesses and increase revenue to the District.

Mayor's comments

"The groups responsible for obtaining compliance with the personal property tax and the other business taxes have coordinated their activities on an informal basis in the past. A study is currently in process to ascertain the most efficient and effective way of formalizing and expanding this coordination."

CLOSER MONITORING OF
TAX EXEMPT ORGANIZATIONS

The District does not appear to have an adequate program for monitoring exemptions from franchise and sales taxes. DFR was not obtaining periodic reports from exempted organizations to insure their continued exemption; it provided very little guidance to such organizations on what portion of their operations had to be in the District to exempt them from District tax.

As of November 1, 1974, DFR records showed 1,472 organizations exempted from District franchise taxes and 3,433 organizations exempted from sales taxes. DFR did not have data on revenue foregone or the scope of these organizations' exempted operations.

The basic criteria for all District tax exemptions are that the organizations be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes and that no part of the net earnings benefit any private shareholder or individual. These are also the criteria under which Federal income tax exemption is granted, pursuant to section 501(c)(3) of the Internal Revenue Code. In addition to these criteria, the District's Income and Franchise Tax Act of 1947 provided that such organizations must dispense their benefits "to a substantial extent" within the District.

The District does not explain specifically to organizations applying for exemption from income and franchise tax what it considers "a substantial extent" to be. District personnel responsible for reviewing exemption applications said that the word "substantial" indicates that judgment is involved, and in reviewing an application, they consider the amount of money the organization spends or the services it provides in the District. If the organization's activities benefit the District to a recognizable extent, it usually is regarded as meeting the criteria for exemption.

The District does not receive current information on the status of organizations granted exemptions from either the franchise or sales taxes. The DFR personnel who administer the exemption program said that organizations exempted from income and franchise taxes usually do not furnish the annual reports the District asks for in the letter notifying them of the approval of their applications. In the case of sales exemptions, no periodic reporting requirements exist, even though sales tax certificates have no expiration date and could conceivably

be used long after the organization ceased to qualify for exemption. DFR officials said they had no specific procedures for monitoring exempt organizations' operations.

Unless the District keeps current information on the operations of exempt organizations, the District could be put at a disadvantage. For example, charitable foundations and trusts which generate income in the District through investments or other profitmaking ventures might redistribute their charitable benefits to make their exemption from District taxes disproportionate to the benefits distributed in the District.

New York State recognizes the desirability of keeping the contributions of exempt organizations flowing to the State and has established an active program for supervising charitable trusts and foundations. Under New York's program, such organizations must report annually in order to keep their exempt status. To offset the expense of State supervision, the organizations must pay filing fees based on their net worths.

To measure the need for improved supervision of the District's exempted organizations, we devised certain tests which were performed with the assistance of DFR and OMAI. Generally, our tests indicated that:

--Organizations are operating in the District under the presumption that they are exempt from income and franchise tax.

--Other organizations which the District has exempted from franchise and income tax apparently have not been exempted from Federal tax or have had their Federal exemptions terminated.

--Many organizations no longer operating in the District are on record in its active exemption files.

The District needs to review its exemption program with a view toward developing ways to strengthen its supervision of tax-exempt organizations.

Lead to summary of it
The District should define the phrase "to a substantial extent," either from the legislative history surrounding its inclusion in the D.C. Code or by supplemental legislation. Such action would help exempt organizations plan their District activities to maintain their exempt status and provide maximum benefits to the District's residents from the tax exemption program.

Also, the District should consider establishing application filing fees in order to help offset the costs of administering the program.

Mayor's comments

"The Director of the Department of Finance and Revenue acknowledges that more attention could be devoted to the area of tax exempt organizations. He believes, however, that any substantial expanded effort is not practical at this time because of limited resources and higher priority programs. Further consideration will be given to expanding our efforts in this area in the future."

TAX ON RESTAURANT CARRYOUT SALES INCREASED

We also noted a sales tax compliance problem at restaurants which have both eat-in and carryout sales. Food purchases made ostensibly for carryout and taxed at 2 percent were being eaten in restaurant facilities and therefore should have been taxed at 6 percent. The problem was solved, however, by the City Council's subsequent passage of the District of Columbia Revenue Act of 1975 which taxes all food or drink sold by restaurants and similar establishments at 6 percent.

CONCLUSIONS

The District has recognized that the above matters deserve additional attention. To insure that needed changes are made, a definite plan for reviewing each of the areas should be established, including a schedule for completing the reviews and taking appropriate actions.



THE DISTRICT OF COLUMBIA

WALTER E. WASHINGTON
MAYOR

WASHINGTON, D. C. 20004

JUL 1 1975

Mr. Victor L. Lowe, Director
General Government Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

Thank you for the opportunity to comment on your draft report concerning a review of the administration of the District's self-assessed taxes.

Your principal recommendation is that the District should develop a more formal system for identifying, analyzing, and documenting various problems with voluntary compliance in order to better assure that appropriate action is taken to further reduce such problems. To accomplish this, GAO suggests compiling certain additional statistics.

Although the accumulation of additional detailed statistics will infringe on the revenue production of our extremely limited staff resources we nevertheless agree that it is possible that additional useful knowledge about taxpayer compliance problems might result. Therefore, more detailed statistics will be developed where reasonably feasible.

As you know, numerous actions have been and continue to be taken to improve voluntary compliance with the District's tax laws. Projects have already been initiated to accumulate more detailed statistics on tax audits and on the questions most frequently

asked by taxpayers. The Director of the Department of Finance and Revenue has advised me that his current program plan contains more specific projects directed toward improving voluntary compliance. The District Government will support the Director's programs for improving the effectiveness of activities conducted to improve voluntary compliance with our tax laws.

The draft report discusses four additional matters and contains recommendations that (1) the Director of the Department of Finance and Revenue evaluate each area and initiate the actions he deems appropriate and (2) the District Government take such legislative and budgetary steps as may be warranted based on the Director's evaluations. My comments on each of these matters follow.

Establish master (historical) computer tax file for the individual income tax and expedite the completion of the computerized master business tax system.

We are in agreement with your general observations on this subject area. As you know, we have developed consistent with available resources limited capacity in the business tax area. Furthermore, the fiscal year 1976 budget submitted to the Congress contains a request for funds to initiate a study and analysis of further needed improvements in the Department's computer utilization.

Better coordinate compliance activities for personal property tax and other business taxes.

The groups responsible for obtaining compliance with the personal property tax and the other business taxes have coordinated their activities on an informal basis in the past. A study is currently in process to ascertain the most efficient and effective way of formalizing and expanding this coordination.

The Director of the Department of Finance and Revenue has advised me that he will let me know if implementation of improved coordination will require any assistance or action by my office.

Monitor tax exempt organizations more closely.

The Director of the Department of Finance and Revenue acknowledges that more attention could be devoted to the area of tax exempt organizations. He believes, however, that any substantial expanded effort is not practical at this time because of limited resources and higher priority programs. Further consideration will be given to expanding our efforts in this area in the future.

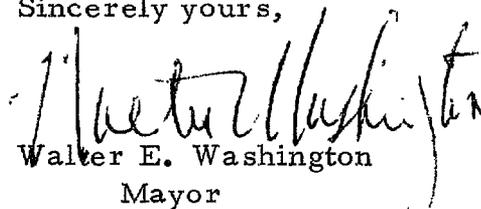
Revise the tax on restaurant carry-out sales.

The problems referred to in your report regarding restaurant carry-out sales have been solved legislatively by provisions contained in the Revenue Act of 1975. Specifically, food (groceries) previously taxed at a 2% rate has been exempted from the sales tax. The only food item which is currently in the sales tax base at the 2% rate is that sold in vending machines. Accordingly, the sales tax rate on prepared food (restaurant meals, etc.) is the same (6%) whether the food or drink is actually consumed on or off the premises where sold.

We appreciate your suggestions. We know that there is always room for improvement in any program and the District is constantly seeking ways of making such improvements. Moreover, I was pleased to note that the findings in your report were in the nature of constructive suggestions for essentially "fine-tuning" our existing tax administrative operations.

Again, I thank you for allowing me to review the report in its draft form and I hope that these comments will be helpful to you in finalizing the report.

Sincerely yours,


Walter E. Washington
Mayor

PRINCIPAL DISTRICT OF COLUMBIA OFFICIALS
CONCERNED WITH ACTIVITIES
DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
MAYOR (note a): Walter E. Washington	Nov. 1967	Present
DIRECTOR, DEPARTMENT OF FINANCE AND REVENUE: Kenneth Back	Mar. 1969	Present
<u>a/</u> Position was entitled Commissioner until January 2, 1975.		

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