



## Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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Joint Committee on Finance

Paper #686

### **Penalties for Failure to Produce Records (DOR -- Tax Administration)**

[LFB 2009-11 Budget Summary: Page 562, #12]

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#### **CURRENT LAW**

Under current law, the Department of Revenue (DOR) may examine or cause to be examined any books, records, papers, proof material, or similar documents, and may require the production of documents and the attendance of any person having knowledge and take testimony. The Department may summon witnesses to appear and give testimony, and produce records and documents relating to any matter which the Department has the authority to investigate or determine. Under sales tax provisions, any person who fails or refuses to file, submit, prepare, or retain returns, certificates, forms, reports, or data at the time and place, and in the manner required, is guilty of a misdemeanor for each such failure or refusal.

#### **GOVERNOR**

Establish a penalty for failure to produce tax records or documents.

#### **DISCUSSION POINTS**

1. DOR is required to office audit individual and corporate income and 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. DOR is also statutorily authorized to conduct office and field audits of state sales, use, and excise taxes.

2. 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.

3. 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.

4. Records are requested during field audits and office audits as necessary to make an

accurate determination of the tax liability. During a field audit, records can be requested from a taxpayer at various times, and in a number of different ways. Typically, there is an initial request sent to the taxpayer for records to be provided when the auditor arrives at the taxpayer's location to begin the audit. Record requests are made both verbally, and in writing by letter, e-mail, or Departmental form. There is not an established time period for notification of records requests prior to an audit. There is also no standard response time within which a taxpayer must provide records. However, the auditor does typically set a deadline for when a taxpayer is to provide records.

5. Under the provisions recommended by the Governor, a person who failed to produce records or documents, as required under current law, that supported amounts or other information shown on any return required under state income, franchise, or sales taxes would be subject to any of the following penalties, as determined by the Department:

a. The disallowance of deductions, credits, or exemptions to which the requested records relate.

b. In addition to any penalty imposed under current law, a penalty for each violation that was equal to the greater of \$500 or 25% of the amount of any adjustment by the Department that results from the person's failure to produce the records.

The penalties would increase annual state revenues by a minimal amount.

6. DOR indicates that it must undertake additional actions in cases where taxpayers refuse or delay in providing records and documents during an audit. The Department uses a subpoena for the records and/or issues an estimated assessment based on available information. According to DOR, these cases occur with many types of taxpayers, and in some cases, taxpayers delay in providing requested records for months, or even years. However, the Department does not compile statistics on audits that involve taxpayers that do not provide requested records. DOR views the proposed penalty for failure to produce records as an incentive for taxpayers to cooperate with auditors from the beginning of an audit.

7. Studies have found that an increase in the fine rate on tax returns slightly increases compliance. The income fine rate elasticity is about 0.1, meaning an overall 10% increase in all penalties would result in a less than 1% increase in collections (Alm , 2008).

8. A number of states have penalty provisions for failure to produce records. The specific states and related penalties are listed below.

Florida -- The Circuit Court has jurisdiction, and upon application by the Department of Revenue, issues orders securing compliance.

Louisiana -- In a court hearing, the taxpayer must show cause why the Department of Revenue should not be permitted to examine books, records, or other documents, and to enter a judgment of contempt punished according to law.

Mississippi -- The taxpayer forfeits the right to do business in the state until the taxpayer

complies with the request. An injunction can be brought by an authorized court to prevent the business from operating.

North Carolina -- Failure or refusal to produce records is reported to the Attorney General or the district solicitor who can start court proceedings. The taxpayer must show cause for the failure or refusal to produce the information. The court has authority to punish the taxpayer for contempt.

Pennsylvania -- A taxpayer who fails to provide records is guilty of a misdemeanor, and subject to a fine of \$400, or up to six months in prison.

Texas -- A taxpayer that fails to produce records forfeits the charter or permit to do business in the state.

Virginia -- Taxpayers that fail to provide records are guilty of either a Class 4 or Class 2 misdemeanor, depending on the type of tax. Each month in which the taxpayer does not produce records is a separate offense.

Washington -- Taxpayers that fail to produce records are guilty of a gross misdemeanor.

9. DOR indicates that the language in the bill is general and that the Department would need to adopt an official policy regarding administration of the penalty. Issues that would be addressed include: (a) a standard response time for a taxpayer to provide the requested records; (b) a standard number of times a taxpayer would be given the opportunity to provide records; and (c) guidelines for waiving the penalty if the Department was satisfied the requested records did not exist. However, DOR notes that specific statutory language would reduce its future flexibility as electronic alternatives became available. An alternative would be to require the Department to promulgate rules that included a standard response time, a standard for noncompliance, and penalty waivers. This would provide a means for legislative review.

## **ALTERNATIVES**

1. Adopt the Governor's recommendation to establish a penalty for failure to produce tax records or documents.

2. Adopt the Governor's recommendation to establish a penalty for failure to produce tax records or documents. In addition, require the Department to promulgate administrative rules that include a standard response time, a standard for noncompliance, and penalty waivers.

3. Delete the Governor's recommendation.

Prepared by: Ron Shanovich