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## Tax Collection Methods: Understanding Business Tax Collection and the Psyche of Evasion

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# **Tax Collection Methods: Understanding Business Tax Collection and the Psyche of Evasion**

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## Executive Summary

“Taxes are the life-blood of government, and their prompt and certain availability an imperious need (Justice Owen J Roberts, Bull V US 295 U. S. 247 (1935))” (Scharf). Tax collection is necessary to ensure revenues are collected to fund governmental services. States are losing tax revenue for a variety of reasons; this paper explores some of the major factors causing states to lose out on tax revenue. It addresses the tax gap, or unpaid taxes due and the economic inefficiencies caused by tax evasion. It analyzes the psyche of noncompliance in an attempt to discover the most efficient manner of collecting taxes. This understanding of noncompliant behavior is used to help identify the most effective tax collection methods available.

This study focuses on the Kentucky Department of Revenue, Division of Collections, Corporation/Limited Liability Company Branch. The CP/LLC Branch focuses on enforced collection activities against corporations and limited liability companies. The enforced collection tools available to the branch are: jeopardy assessments, corporate officer notice of assessments, limited liability company member notice of assessments, final notice before seizures, liens, bank levies, and wage levies. Data from the CP/LLC Branch from July 2006-June 2009 were used to determine which of the enforced collection activities listed above have the most effect on total collections revenue. A lag regression analysis model was used. This was to account for mail float and response time. This analysis found a positive relationship between only one of the enforced collection activities and collections revenue, officer Notice of Assessments (NOA). A positive relationship was also discovered between total collections revenue and both the total number of cases in a previous month and incoming calls in the current month.

These three factors, officer NOA's, number of collection cases, and incoming phone calls all effect total collections in a statistically significant positive manner. There are other collection activities that a priori might seem to be related to these factors as well, but this analysis showed no connection. First, though the number of cases in collections has a positive effect on collections revenue, the total amount of accounts receivable for collections does not have the same relationship. This analysis showed that more cases entering collection leads to more collections revenue, independent of accounts receivable. This relationship could mean that cases new to collections are more likely to make payments. With this knowledge, management could decide to have collection officers focus on cases new to collections. Second, incoming calls have a positive influence on collections revenue. This was the least surprising part of the analysis. An incoming call from a business ensures that someone is contacting DOR concerning the case. When taxpayers are contacting the CP/LLC branch they are usually trying to work toward resolution. Another possible explanation for the correlation could be that taxpayers are calling in due to a refund offset. If a taxpayer owes tax liability for a business or for their individual income and he or she has been properly assessed as an officer of the business, then any tax refund due to that person, state or federal, will be offset and applied to the tax debt. These offsets often prompt an incoming call. This information emphasizes the importance of adequate phone coverage to CP/LLC Collections.

The only enforced collection action shown to have a statistically significant effect on collections revenue is the officer NOA. Currently, collectors are instructed to wait until there is a total trust tax due of at least \$1000(including tax, penalty, and interest) before starting officer NOA action. I recommend that management decide to lower this threshold, at least for the purpose of corporate collections (the same relationship was not found between LLC member NOA's and collections revenue).

## **Introduction**

This paper explores tax collection issues facing government entities, focusing on the Commonwealth of Kentucky. Governments across the US are losing out on tax revenue for a variety of reasons. The recent recession has caused serious budgetary concerns for states across the nation. Historically, state tax revenue has continued to fall, even after the recession has ended. This means that states will continue to have potential revenue shortfalls, even after most other parts of the economy have recovered. Due to the loss in revenue, states have been trying to collect all possible outstanding taxes. This paper explores the tax gap, also known as the amount of taxes due that are not being paid. The presence of tax evasion leads to the question, why do certain people decide to pay their taxes and why do others choose to evade? Certain professions have high rates of tax evasion. This paper discusses the repercussions of these types of evasion. It also discusses what levels of enforcement are needed to produce the best results. Due to anecdotal tales of aggressive IRS collection actions, later found to be unsubstantiated, the federal government enacted the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA). This affected the way the IRS went about collecting delinquent tax revenue. This paper explores that act and the effects it has had on tax collection.

## **Loss of Tax Revenue**

States across the U. S. are losing tax revenue for many reasons. In the third quarter of 2009 tax collections fell 11% across 44 states. There was a drop in every major revenue source including

sales tax, corporate tax, and personal income tax. The steepest decline was seen in corporate income tax, which declined 19.4% across the 44 states. Corporate income tax is the most volatile of the tax types. This is because tax receipts are heavily dependent on wages and spending, so the recession has hit the states especially hard (Dougherty). Historically tax collections continue to fall even after a recession is over and often end up fallen farther than the rest of the economy. Current tax collections have already fell past the low point of the 2001 recession. Once GDP does hit the ground state legislators will likely still have to deal with falling revenue for some time (State Legislatures).

Aside from the recession, there are other factors causing the state to miss out on tax revenue. For example, large companies such as Microsoft and Google have moved operations to lower tax rate jurisdictions, such as Ireland to avoid higher corporate income tax rates in the US (Saltmarsh). Corporations that rely heavily on internet sales are using similar tactics to avoid paying sales tax. This is justified due to the Supreme Court decision *Quill v North Dakota*. This decision was made because the Supreme Court saw that requiring businesses to comply with tax regulations for 45 states and around 7,500 jurisdictions would burden interstate commerce. This case dealt with a mail-order catalogue company and the ruling was then applied to all remote sellers, including internet sales (Institute for Local Self-Reliance). But, new computer software programs significantly alleviate this problem as does the Streamline Sales Tax program put in place by a growing number of states. Whether or not a corporation is liable for charging sales tax is determined on the grounds of NEXUS. NEXUS is determined by physical presence. For the most part, if a corporation does not have a physical location in a state and they use a third party mail carrier (such as the USPS) to deliver their packages then they are considered to have no NEXUS in that state and pay no sales tax.

Companies make strategic decisions as to where to locate their businesses based on the amount of sales tax they are going to be subjected to. Companies also avoid paying Sales Tax in a particular jurisdiction by using entity isolation, which means creating a separate corporate entity to avoid NEXUS classification.

### **Tax Gap**

Falling revenues across the states makes collection of delinquent taxes essential. “Taxes are the life-blood of government, and their prompt and certain availability an imperious need (Justice Owen J Roberts, Bull V US 295 U. S. 247 (1935)).” (Scharf) Tax evasion and tax avoidance have been a part of taxes since tax collection began. Studies suggest that tax compliance is the norm for most people in the United States (Lederman). Governments cannot rely on the population to pay taxes unregulated. If there were no regulations or penalties, some citizens would still pay their taxes but these numbers would decrease as time passed. Taxpaying citizens will stop paying when they realize they are being taken advantage of by the non-taxpaying citizens. This is why it is the legal responsibility of citizens to pay taxes; it is also why there are penalties charged for noncompliance with the tax laws (Slemrod).

It is difficult to account for all of the tax that goes unpaid. Most noncompliance can be grouped into three categories: failure to file, failure to pay, and failure to report (Lederman). Survey instruments commonly used to determine compliance are not reliable; people are not likely to admit to not paying taxes and possibly incriminate themselves on a survey. Also the line between tax evasion and tax avoidance can be blurry. For tax evasion to be considered illegal, it must be an overt act; it is difficult to decipher what someone’s intentions are. It is unlikely that an empirical analysis will precisely identify a person’s intentions (Slemrod).

The IRS has made estimates of what it terms the “tax gap” or how much tax should be paid but is not. It calculates this measure by combining information from the Taxpayer Compliance Measurement Program (TCMP), information from ongoing collection action, and studies about sources of income. The United States maintains the most robust information reporting of any country in the Organisation for Economic Co-Operation and Development (OECD). Common examples of professions with higher tax evasion are painters and nannies; this is because these services are often paid for in cash. These types of noncompliance may be difficult to uncover, even with the most intense audit. The most recent gross tax gap estimate is \$345 billion or 16.3 percent of estimated actual tax liability, including paid and unpaid federal taxes.

Businesses are given the responsibility to withhold taxes from their employees’ paychecks and remit that to the respective government entities. These employee withholdings are matched with what the business reports on the W2 at the year-end as well as what the individual reports on their income tax return. At the federal and state level, businesses are also required to pay income tax. The noncompliance rate, including all type taxes, for large corporations (businesses with more than \$10 million in assets) is 14 percent, while the noncompliance rate for small corporations (businesses with less than \$10 assets) was 29 percent. These estimates of underreporting are difficult to compute due to the complexity of the tax laws. When the tax liability is disputed, it is often a long process for resolution which may involve taking the argument to court. In 2005 Mark Everson testified that the IRS had “a reputation for trading [penalties] away.” This entails that it may not be in the best interest of the business to pay the initial amount the IRS claims is due (Slemrod). In my own experience as a tax collector for the state of Kentucky, I would have to agree with this assessment. Oftentimes it is more costly to argue and take a taxpayer to court than it would be to

waive the penalties and accept tax and interest as payment in full. In a case like this, the collector must make the decision as to what is best for all parties involved. There are many long term effects of non-compliance. If the tax rate is adjusted up to account for the underpayment, then corporations that are reporting a loss will still not bear their fair share of the tax burden (Slemrod).

### **Internal Revenue Service Restructuring and Reform act of 1998**

The IRS's enforcement activities have gone down in the past years and face to face audits have dropped as well. This is most likely due to the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA). This measure was passed due to anecdotal 'horror stories' concerning the IRS. After further review it was concluded that there was little evidence to substantiate the anecdotal stories. The IRS was concerned with its efficiency, personnel skills, possible abuses of power, and the image of the agency. The IRS's poorly implemented computer system, which had a price tag of \$4 billion, also drew criticism and legislative concern that led to the RRA. There were many effects of RRA. One was a change in the focus from geographical sections to one based on taxpayer category. The RRA made supervisor approval necessary for aggressive enforced collection actions. The burden of proof was also shifted from the taxpayer to the agency itself (Slemrod).

The RRA came about due to concerns with the apparent "friendliness" of the IRS. This raises the question, does increase "friendliness" or a softer tone affect the level of remittance? Through the RRA the IRS has shifted its focus to service. Service, for the IRS, is assisting taxpayers in becoming compliant with the tax laws using due process and equality of treatment. Experiments conducted by the Minnesota Department of Revenue suggest that providing more service to taxpayers does not affect the level of voluntary compliance. The IRS also conducted a study that



found issuing refunds faster and volumes at Taxpayer Service offices do not have a positive effect on compliance. Providing these resources for taxpayers comes at a cost, and the benefits have yet to be seen. Though perceived fairness may have a positive effect on compliance or more likely perceived unfairness has a positive effect on noncompliance. An agency should practice good tax collection procedures. This involves keeping individual information private, not threatening individuals, making the process as simple as possible, and not intruding unless necessary (Lederman).

Tax collection agencies have three main enforcement tools: levies, liens, and seizure of property. For the IRS, the use of each these enforcement tools has decreased since the RRA. A levy takes place when the IRS seizes assets from the taxpayer's bank accounts or personal wages. A tax lien puts a hold on all assets and stops the sale of any property until the tax liability is paid in full. Levies fell from 3.1 million to 2.2 million between 1996 and 2004, liens fell from 750,000 to 534,000 and seizures fell from 10,449 to 440. This could be a temporary dip in enforcement due to the reorganization efforts of the RRA. During this time, the tax laws have become much more complex and tax shelters have become more sophisticated, which will make detecting evasion more difficult.

### **The Psyche of Paying and Reporting Taxes**

One question tax collectors should ask is, what makes a person decide to evade their taxes or conversely what makes a person decide to voluntarily report and pay their taxes? It has been argued that the decision to comply is based on the likelihood of being audited, which is around one percent for individual returns with no Schedule C filed (business income) versus the average penalty amount of 10 percent of unpaid tax due. But, due to the auditing procedures of the IRS, this argument does not work well. An individual reports their income based on their W2 wages, which are also reported

by the individual's employer. If these two figures do not match, the likelihood of an audit is closer to 100 percent.

Some argue that there is a more intrinsic motivation to pay tax liability. People are performing their civic duty. There is also the extrinsic motivation for avoiding the threat of being penalized for noncompliance. Increasing the penalties in an attempt to increase the extrinsic motivation may have a crowd out effect on the intrinsic motivation of civic virtue. If people do not feel as if they are being treated fairly they are going to be less likely to have those feeling of civic duty and less likely to comply with tax requirements. An experimental study conducted by Sholtz and Lubell (2001) found that the level of cooperation decreases when penalties are introduced. This suggests that tax legislation should consider both intrinsic and extrinsic factors. Penalties are necessary as a deterrent for noncompliance, but over penalizing may crowd out the taxpayers who are willing to pay their fair share of the tax liability. Also, the perception of fairness is important. If the taxation system is seen as fair and equitable, then it is more likely that noncompliance will be viewed as a more serious offense by the public. Some may form their tax compliance habits based on their view of governmental policy, if they do not support governmental policy then they may be less likely to comply. This suggests that the actions of the government and the perception of these actions are important in taxpayer compliance. If taxpayers believe that the government is acting on their behalf and they will be treated fairly, then they may be more likely to comply. A survey in the Czech Republic found that people were less likely to pay their taxes if they felt government services were substandard. The question governments need to ask is, to what extent they can utilize feelings of patriotism to encourage tax compliance. This effect has not been proven through empirical studies. It is also difficult to decide which taxpayers pay their taxes due to fear of being penalized or

as part of their civic duty or a mix of the two. In a 2005 survey 96 percent of participants agreed that “It is every American’s civic duty to pay their fair share of taxes,” while 62 percent stated that fear of being audited influenced their reporting and paying (Slemrod).

### **Compliance Norms**

Some argue there is a general societal norm for compliance. Detection alone cannot account for the high level of compliance in the United States. People who think it is right to comply typically believe in the legitimacy of the IRS and its operations. Those who are regularly exposed to others with positive views of the IRS are more likely to be compliant. People also believe that others cheat more than they do, if they themselves cheat on their taxes (Lederman). This implies a moral standard that is reflective of someone’s beliefs about tax compliance, based on their perception of the compliance of others. In basic economic terms, more people are likely to contribute to a public good when they think others do, a sort of fairness norm. They at least need to have the perception they are not being taken advantage of; this could be part of the norm of reciprocation, internalized from childhood. Many people are conditional cooperators and their compliance depends on the compliance of others. In the same manner, these people could factor in the government’s contract to them to provide certain public goods.

Taxpayers can be grouped into three groups: compliant, susceptible to influence, and non-compliant. The middle, susceptible to influence group should be the target of measures to increase compliance because they are most likely to change their behavior. In a study done by the Minnesota Department of Revenue, taxpayers were sent two different forms of a letter. One letter suggested that most people are compliant but enforcement measures are being taken to catch noncompliant citizens. The second letter emphasized the punitive consequences of not filing. The study found

that the taxpayers who received the letter suggesting others were mainly compliant reported more income on average on their next year's return, suggesting that they are being more honest about their income. This shows that people are affected by what they perceive to be a societal norm. Knowing this, governments can focus on fostering a societal norm of compliance (Lederman).

### **Enforcement**

Some strict enforcement efforts by the IRS have backfired. When the IRS makes a grand gesture focusing on non-compliance this may cause taxpayers to believe that there are more people who are not compliant. This thought could cause a reciprocal move to noncompliance for those on the border about their own compliance standards. But, enforcement cannot be ruled out as a factor in compliance. Enforcement can assure compliant taxpayers they are not the only ones contributing to government services. States with higher proportion of criminal prosecution do have higher levels of compliance. This is not to say that criminal prosecution is a benefit. The benefits of criminal conviction for tax evasion have to be weighed against the exorbitantly high cost of court cases. This knowledge is useful though. Governments could utilize media outlets to publicize criminal convictions, emphasizing that compliance is the norm but cheaters do get caught and have to face the penalty (Lederman).

Governments should be concerned with fairness and efficiency. Tax evasion not only affects the government but it also affects its tax complying citizens. They are the ones who are left with the burden of financing government activities while tax evaders do not pay their share of the tax burden. Locating tax evaders and collecting tax due comes at a price and governments have to keep this in mind when developing tax policy. If everyone underreported their taxes, then the solution would be to simply raise the taxation rate for everyone to make up the difference, but

widespread evasion is not the case. Raising tax rates to compensate for the tax gap would only be penalizing the taxpayers who timely file and pay their taxes. Since tax evasion is seen throughout all income brackets and population demographics, simply raising the tax rate for one segment would result in serious inequalities. Tax evasion also imposes efficiency costs. It takes resources to weed out noncompliant taxpayers and it also takes effort and resources on the part of the evader.

There are also social inefficiencies involved. Certain professions are more likely to get paid in cash, for example a house cleaner. The cleaner who does not pay taxes on their income can charge a lower price. The lower price offered by the non-taxpaying cleaner will then unfairly bid down the price for the taxpaying cleaner, causing inefficiency in the market. This will not give the honest cleaner much incentive to continue their taxpaying practices. It is also possible that there is a form of adverse selection involved in this scenario. Tax evaders opt to participate in businesses with high instances of tax evasion because they are less risk averse. This creates a social norm of noncompliance.

The presence of tax evasion does not mean that the tax policy is inherently flawed, but there are tax policies governments can enact to minimize this loss. Governments have to make decisions as to what extent they are going to audit returns and pursue collection actions. Setting penalties too high opens up the door for corruption in tax administration. Plus, it makes it more likely that someone will be heavily penalized for an honest mistake. Also, if penalties are exceptionally high, jurors deciding cases in legal proceeding could decide to be more lenient due to the high penalties. Slemrod and Yitzhaki (1987) show that governments should invest resources so as to increase the probability of detection until the marginal increase of revenue equals the cost of doing so. Though this seems to be a reasonable theory, it is incorrect. The cost of collection is a true cost but the

collected money is a transfer of funds from the noncompliant taxpayer to the government. This theory suggests that if tax collection was outsourced to private firms working on a for-profit basis will produce socially inefficient outcomes. The proper measure is the marginal social benefit of collecting the taxes, which is not easily measured (Slemrod).

### **Collections Process for the CP/LLC Branch**

There are many collection avenues available to the Commonwealth of Kentucky. This analysis will focus on those regularly used and documented by the Kentucky Department of Revenue Division of Collections Corporation/Limited Liability Corporate Collections Branch (CP/LLC Branch). This branch mainly focuses on collection activity against business entities. Collectors in this branch also log into an automated call distribution (ACD) system where they may answer calls from other branches; primarily the Individual Income Branch of collections. Dollars collected due to these incoming calls from other branches are not recorded as revenue brought in by the CP/LLC Branch.

The primary collection actions taken in the CP/LLC Branch are outgoing phone calls, Tentative Assessment, Notices of Assessment (NOA's), Liens, Final Notice Before Seizures, and Levies (wage and bank). In addition, other factors affecting collection activity include refund offset letters, officer protests, total employees in the branch, total number of collection cases, and incoming phone calls. Each collector has discretion in executing each of the collection activities listed. There are general collection procedures that collectors follow as well as statutory requirements governing the collection process.

When a case enters the CP/LLC Branch, it is put into a work list with other cases new to collections. Collectors know they need to make a phone call or exhaust all research methods for finding a valid phone number before routing the case on to further collections. This is the only stage of collections in the CP/LLC Branch where a phone call is explicitly required. Collectors are always encouraged to call taxpayers, but enforced collection actions must proceed if a suitable arrangement cannot be reached between the taxpayer and the Commonwealth or if the taxpayer cannot be located. As part of the general guidelines of CP/LLC Branch a phone call is attempted each month, but this is up to the discretion of the collector and the status of the case.

When a business initially enters into the collections system due to a delinquency or new bill, many phone calls are made or attempted. Before a case reaches the CP/LLC Branch it goes through the “Front End” where form letters are automatically generated and phone calls are attempted. The goal of these letters and phone calls is to get the taxpayer in compliance before enforced collection action is needed. Once the case has progressed beyond the front end/initial stages of the collections process, it is up to the collector’s discretion as to whether or not to make a phone call for each new delinquency that occurs in the case. It is common practice to attempt a phone call each month. If the case is in collections due to a delinquent return(s) and there is no response to the letters sent, phone calls made, then a Jeopardy Assessment is created for the delinquent period(s). JA’s are bills created for a delinquent period and are statutorily final, due and owing until paid or adjusted based on a filed return. A delinquency showing that the return was not filed will appear in the business’s collection case approximately three months after a return is due; an unfiled past due return is delinquent even if the delinquency is not showing on the collections case. Unfiled returns are a concern due to their uncertainty. When a return is not filed by the business, the amount of tax

due for that period is unknown; the business could owe the state a large sum of money. JA amounts are ideally equal to or larger than the tax amount that would have been due if the return was filed and the division generally doubles the amount suspected due. The taxpayer may elect to pay a JA instead of filing the return, leading the Division to increase the amount of any future JA's issued for that taxpayer. The JA is also designed to elicit a response from the taxpayer; often times taxpayers will be concerned because the amount due is set higher than their usual amount of tax due. The ultimate goal of this process is to get the return filed. But, if the Commonwealth cannot get the business to comply, the JA serves the secondary purpose of recuperating possible taxpayer revenue for the state.

A Notice of Assessment (NOA) is a letter sent to the responsible party of the business. The Commonwealth has statutory authority to hold an individual personally responsible for 'trust taxes' owed by the business. A tax is considered a trust tax if it is collected by the business from a consumer and not a tax levied against the business or its assets. The most common examples of these type taxes are Sales and Use tax, Employee Withholding tax, and Coal Tax. The tax revenue due from trust taxes is not the business's revenue in the first place; instead it is money collected from another consumer/employee and the business is charged with the responsibility to remit these taxes on behalf of the taxpayer. An individual is considered to be an officer based on a variety of measures. If they are the responsible party, typically the president of a corporation, or member of a LLC, then they are considered to be the officer. A collector confirms officer accuracy on the Secretary of State website before sending the NOA to the officer. Corporate returns filed by the business also list the officers and officer liability can be determined based on these returns. The financial controller of a business may also be considered liable, if it is proven he or she had sufficient



control of the business's financial matters. Evidence of this could be checks and/or returns signed by the individual. Once the NOA is sent to the officer's home address, the officer has 45 days to protest their personal liability. At this point it is the officer's responsibility to protest and prove they are not the responsible party. If an officer does not protest, he or she is liable for the tax notices explicitly listed on the NOA.

Collectors can also file tax liens. Tax liens are filed at the county court house, typically in the county where the business is located. If a business is located outside of the Commonwealth, then the lien is filed in Jefferson County. A tax lien can be filed on the business at any time there is a balance due; procedurally a lien is not filed until the total due on the case is at least \$250. Legally a lien can be filed on the officer once their NOA protest date has expired and there is still a NOA'ed liability due. When a tax lien is filed it covers all assets owned by the business or officer. Assets are tied to their owner based on the business's federal identification number or to the officer based on their social security number. A lien gives the lien holder the legal right to that property. The property cannot be sold, mortgaged, or used for collateral when there is a lien in place. The tax lien will not be released on the business until all liability is paid and all returns filed. Since an officer must receive a NOA for any liability they are going to be held personally liable for, so the officer's lien will stay in place until all NOA'ed liability (past the protest date) is paid. Even after the lien has been satisfied it will remain on the business's or individual's credit report for up to seven years.

A Final Notice Before Seizure (Final Notice) is sent via certified mail. This letter can be sent to the business when there is any amount due; DOR will typically wait until the liability is over \$500. The Final Notice is either sent to the business, at the business address or to the officer's home address. Officer liability has to have been NOA'ed and the NOA protest date expired before

it can be included on a Final Notice to the officer. The entity receiving the Final Notice is also charged the cost of sending the certified letter. It is notated in the case whether or not the taxpayer signed for the Final Notice or someone else, though this has no actual bearing on the case or the legitimacy of the Final Notice. Once the Final Notice has been signed for, there is a 30 day grace period given for the officer to respond and make payment in full or set up a pay arrangement suitable to DOR. If there is no response then DOR has the right to levy the assets up to the amount due for all notices listed on this or any previous Final Notice.

Levies are typically one of the last steps taken before a case is routed to the Legal Branch for injunction or other collections measures through the court system. There are two main types of levies: bank levies or wage levies. A levy cannot be done on a particular notice or bill unless a Final Notice has been issued for that particular notice, the Final Notice has been signed for or left unclaimed, and 30 days have passed since the date it should have been received. A bank levy is sent to the bank listing the notices, type of tax, and the total amount of money included in the levy. DOR has banking information because taxpayer's bank information is logged when any payment is made to the Commonwealth. There is also a data match program requiring banks to share debtor information with the state. When a bank receives a levy it is like a onetime snapshot of what is in the account. After the levy hits, any deposits made after will be free and clear. For example if the total debt listed on the levy is \$1000.00 and at the time the bank receives the levy there is \$500.00 in account of the party listed on the levy, the bank will place a hold on that \$500.00 and possibly notify the taxpayer. If the taxpayer goes to the bank the next day and deposits another \$400.00 then that amount will not be held due to the levy. Banks will also hold levy funds for up to twenty days. Presumably, this is to allow the taxpayer time to discuss their tax issues with the Commonwealth.

For example, if some of the bills listed on the levy are JA's there is a possibility that the taxpayer will owe less than the amount captured on the levy once the JA bills are adjusted. If the taxpayer files these returns then the amount of the levy can be reduced to the actual amount of tax owned. If the bank does not receive a release or reduction from the Commonwealth the money will then be forwarded on to the Department of revenue to be applied to the tax case. A bank levy could be released if the taxpayer provides certified funds or if for some reason the debt was paid or resolved between the time the levy was sent and the time the bank received the funds.

Wage levies, sometimes referred to as wage garnishments, are sent to the debtor's employer. The Department of Revenue typically receives wage information from Unemployment Insurance. The wage levy lists the notices of tax due individually as well as the total amount of money due to be collected through the levy. In the case of the wage levy, the employer receives the levy and is instructed to give the taxpayer a portion of the form to fill out listing his or her dependents. The taxpayer is allowed to receive \$60 per week of their wages for himself or herself, plus \$30 a week for any dependents or an unemployed spouse. If the taxpayer does not fill out the form they will only receive \$60 per week of their paycheck and the remainder is forwarded on to DOR. It is unlikely a wage levy will be released before the debt is paid in full. Employers who do not cooperate can face criminal prosecution.

## **Research Design**

There are different areas of tax collection for the Commonwealth of Kentucky. This study focuses on the Corporate/Limited Liability Corporation branch (CP/LLC branch). The branch is part of the Division of Collections in the Department of Revenue which is part of the Finance & Administration Cabinet. The CP/LLC branch is the final step in the collections process before the Legal branch reviews a business for injunction action. The CP/LLC branch performs a variety of collection action. The problem I am going to address in which enforced collection activities result in the most collection revenue.

Before a collection case is assigned to the CP/LLC branch, it has already been through two other branches. The case begins in the Telephone Contact branch where phone calls are attempted using an automated dialer and form letters are mailed out instructing the taxpayer to contact the branch to resolve their tax issue. When the case enters the Contact branch, an additional phone call is attempted; research is conducted to confirm addresses, phone numbers and operating status. If the Contact branch is unsuccessful in resolving a CP/LLC case, the case is routed to the CP/LLC branch for enforced collection action.

The CP/LLC branch will attempt yet another phone call to the taxpayer in an attempt to resolve the case. If no resolution is reached, a collector then decides which collection action is appropriate, taking in to account basic department guidelines and adhering to statutes that govern the collection process. There are several administrative remedies available to collectors in the Department of Revenue: issuing a Jeopardy Assessment for a delinquent(s) return(s), issuing a Final Notice Before Seizure (Final Notice), filing a state tax lien, issuing a bank or wage levy and/or issuing a Notice of Assessment (NOA) to the corporate officer(s) or LLC member(s). The collector's discretion in what action is best presents part of the problem in that it is not definitively

known which action(s) results in the most revenue or cultivates increased compliance. Discovering which action(s) are most effective will allow more concrete guidelines for collectors to follow in the collections process.

This analysis looks at the number of each specific collection action taken in a month and compares it to the total amount of money received each month credited to CP/LLC Branch collections cases. The model used to analyze which actions result in the most revenue is  $CR = \beta_0 + \beta_1 IC + \beta_2 OC + \beta_3 CP + \beta_4 LLC + \beta_5 L + \beta_6 FN + \beta_7 LV + \beta_8 TA + \beta_9 AJ + \beta_{10} ROF + \beta_{11} PRO + \beta_{12} TE + \beta_{13} AR + \beta_{14} CS$  (see Table 1).

The enforced collection actions are: jeopardy assessments, NOA's, Final Notices, liens, bank levies and wage levies. These will be the independent variables. Revenue collected by the branch is the dependent variable. I analyze the results over three fiscal years from July 2006-June 2009, and using monthly totals. For enforced collection actions, the effect of the action may not take place until the next month. For example, if a Final Notice is sent out (via certified mail), there is some float time associated with this action. When the Final Notice is received and signed for by the taxpayer, the assets of the business cannot be seized until thirty (30) days after the date the Final Notice was signed for. To account for this float time, I examine the issue from multiple standpoints. This is to determine if there is a strong effect if more Final Notices are sent out during a month or if there is an effect due to Final Notices that were sent out the previous month. The formula used for the regression model is  $CR = \beta_0 + \beta_1 CP_{(T-1)} + \beta_2 LLC_{(T-1)} + \beta_3 L_{(T-1)} + \beta_4 FN_{(T-1)} + \beta_5 V_{(T-1)} + \beta_6 TA_{(T-1)} + \beta_7 AJ_{(T-1)} + \beta_8 ROF_{(T-1)} + \beta_9 PRO_{(T-1)} + \beta_{10} TE_{(T-1)} + \beta_{11} AR_{(T-1)} + \beta_{12} CS_{(T-1)}$  (see Table 2). This lag model is the focus of the analysis. Even though the effects of outgoing calls and incoming calls are an important collection tool, they are not included in the regression analysis

of enforced collection activity for two reasons. First, phone calls are not enforced collection activity. Phone calls have been previously made to the business before the case entered the CP/LLC Branch. If the issue was resolved by initial phone calls then the case would not have advanced to the CP/LLC Enforced Collection Branch. Second, it is not practical to associate phone calls made this month with enforced collection actions taken in the previous month.

There could be other casual events that have an effect on the amount of revenue collected. One possible event is the time of year, in that there are times when collections do not follow the typical pattern of tax revenue in some respects. Businesses have varying filing frequencies for different type taxes; these frequencies are dependent on thresholds. For example, if a business's total sales tax is more than \$500.00 in one year, the business is required to file monthly sales tax returns; the higher the tax due, the more frequent the filing requirement. However, the Division of Collections does not administer receipt of tax returns and revenue that were submitted timely. The Division of Collections is charged with collecting delinquent taxes and/or returns due. A return is not considered past due until at least forty-five (45) days after the due date. There is a constant backlog of collection cases and collectors should never be idle. The constant flow of business collection case activity does not make the time of year such an important factor as it might be in

## **Analysis**

The enforced collection activities considered using a lag model were: JA's, officer NOA's, LLC member NOA's, final notices, liens, and levies. Total accounts receivable, number of cases, and total employees were the other factors considered in the regression analysis. Using the model previously described, only two of these activities were shown to have a statistically significant affect

on collection revenues and only one was an enforced collection activity. An officer NOA was the only enforced collection activity that was shown to have a statistically significant positive effect on total collections. A LLC member NOA, which is essentially the same thing as an officer NOA but for a different classification of business, was not shown to have any statistically significant effect on collections. The non enforcement activity that had a statistically significant positive effect on collections revenue was the total number of cases in collections, while the amount of accounts receivable did not.

The different response from corporate officers versus LLC members is very interesting. An LLC is a Limited Liability Corporation. The main ideal behind an LLC is it is a business entity that can elect to file as a corporation or as a partnership/sole proprietorship. This means that the LLC member could elect to file their business taxes as part of their Schedule C on their individual income taxes or on partnership return. Based on the findings of the Literature Review small businesses are less likely to comply with tax regulation versus larger corporations. This could explain why the LLC member NOA does not have the same positive response levels as the officer NOA.

CP/LLC branch guidelines for collections procedures restrict sending NOA's until the total trust tax liability in the case is over \$1000. This is guideline holds for both corporate officer and LLC member NOA's. Knowing that officer NOA's have a statistically significant positive effect on collections, this threshold should be rethought. A threshold of \$500 would allow collectors to send out more officer NOA's which could increase collections revenue.

The other factor that had a statistically significant positive effect on collections was the number of cases. This regression showed that if there are more cases in collections then the total

collections revenue for the next month is likely to be higher. It is important to remember that the total number of cases in collections is distinct from the total amount of accounts receivable. The total accounts receivable is the total amount of tax due for all of the cases in the CP/LLC Branch's control. The total revenue is not related to the number of cases in collections. A case's balance can grow, increasing the accounts receivable, but that is not related to the number of cases in collections. This shows that the number of cases is a better indicator of future tax collection verse accounts receivable. An increase in the number of collections cases would either be due to new cases entering collections or revisiting collections.

A case leaves collections when it is paid in full and there are no delinquencies. Each collection case includes all tax accounts associated with a business's federal identification number, and each case includes all tax debt owed to the state for that business. This analysis showed a statistically significant relationship between the number of business cases in collections and the amount collected. . If there are more cases in collections, this is a result of more businesses having either a delinquent return or a bill with DOR. The number of cases increases due to new cases in collections, more new cases mean more collection revenue, from this I can assume that it is the new cases that are the cause of the increase in revenue. This indicates that the amount of time a case is in collections could have an impact on the amount of revenue collections is going to receive with respect to that case, new cases are more likely to make payments toward their tax liability versus cases that have been in the collection process longer. Focus could be shifted to cases newer to collections.

Incoming calls are also highly correlated with collection revenue. They were not included in the regression lag model because they are not enforced collections. Incoming calls indicate that the



taxpayer is in contact with DOR and is trying to resolve their tax case. There is another potential reason for incoming calls being correlated with collections revenue and that is response to refund offsets. If an individual has been assessed (meaning a valid NOA was sent and the protest date has passed and a final notice sent), then DOR has will offset that person's state or federal refund. This will often prompt an individual to call DOR to inquire about the status of their refund. Incoming calls are an indicator of taxpayer willingness to comply. When a taxpayer is calling DOR and following through with DOR's instruction, enforced collection action is not taken. Typically, collectors are logged into the ACH phone loop for the entirety of their work day, unless working on a special project. The CP/LLC Branch already recognizes the importance of phone calls, if no one in the branch is available for phone calls, the call will 'roll' to another branch where a collector from another area will try to assist the taxpayer. If that person from the other area cannot assist the taxpayer with their business case then the other collector should make sure that taxpayer gets in contact with someone in the CP/LLC Branch.

### **Recommendations**

This analysis leads to some recommendations for the Kentucky department of revenue and the CP/LLC Branch of collections and DOR as a whole. The first action for DOR should be to read through correspondence being sent out to taxpayers and ask the question: does this lead people to believe that compliance is the norm? Anything DOR can do to foster the belief that tax compliance is the norm or most of the population is compliant with their tax obligations. The goal of collections should be to ensure that those few who do not follow the tax laws get punished. The next recommendation would be to recognize the importance of incoming calls. Usually when people are calling, they are trying to work toward resolution. DOR should take this as a signal and

work with taxpayers; always treating taxpayers in an equitable manner, one that that is also equitable to other compliant, taxpaying citizens who are providing tax revenue to support government services. The next suggestion applies directly to the CP/LLC branch of collections. That would be to lower the threshold amount of \$1000 for sending officer NOA's. This amount is arbitrarily set and changing it would only impact the branch and hopefully collections revenue. This was the only collection action shown to have a positive effect on collection revenue.

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$$CR = \beta_0 + \beta_1 CP_{(T-1)} + \beta_2 LLC_{(T-1)} + \beta_3 L_{(T-1)} + \beta_4 FN_{(T-1)} + \beta_5 V_{(T-1)} + \beta_6 TA_{(T-1)} + \beta_7 AJ_{(T-1)} + \beta_8 ROF_{(T-1)} + \beta_9 PRO_{(T-1)} + \beta_{10} TE_{(T-1)} + \beta_{11} AR_{(T-1)} + \beta_{12} CS_{(T-1)}$$

<b>Table 1. Lag Regression Model for Predicting the CP/LLC Collections Branch's Revenue</b>				
<b>Code</b>	<b>Variables</b>	<b>B<sup>a</sup></b>	<b>S. E.</b>	<b>t Value</b>
	<u>Intercept</u>	2209171.72	3789966.49	0.58
CP	<u>Officer NOAs</u>	5430.67	1793.88	3.03
LLC	<u>LLC Member NOAs</u>	2608.85	2423.76	1.08
LN	<u>Liens</u>	244.75	1460.51	0.17
FN	<u>Final Notice</u>	-915.68	1170.45	-0.78
LV	<u>Levies</u>	304.32	1661.75	0.18
TA	<u>Tentative Adjustments</u>	-426.47	399.20	-1.07
AJ	<u>Adjustments</u>	-141.63	877.88	-0.16
RPF	<u>Refund Offset Letters</u>	1159.67	2149.58	0.54
PRO	<u>Protests</u>	-31917.34	24355.65	-1.31
TE	<u>Total Employees</u>	-42199.46	81843.69	-0.52
REC	<u>Receivables</u>	-0.02	0.02	-1.10
CS	<u>Cases</u>	490.59	206.51	2.38

<u>Number of observations</u>	35.00
<u>R- Squared</u>	0.51
<u>F</u>	1.67

\*\*\*P<0.01, \*\*P<0.05

$$CR = \beta_0 + \beta_1 IC + \beta_2 OC + \beta_3 CP + \beta_4 LL + \beta_5 L + \beta_6 FN + \beta_7 LV + \beta_8 TA + \beta_9 AJ + \beta_{10} ROF + \beta_{11}$$

$$PRO + \beta_{12} TE + \beta_{13} AR + CS$$

<b>Table 2. Regression Model for Predicting the CP/LLC Collections Branch's Revenue</b>				
<b>Code</b>	<b>Variables</b>	<b>B<sup>a</sup></b>	<b>S. E.</b>	<b>t Value</b>
	<u>Intercept</u>	112795.58	3638595.14	0.03
IC	<u>Incoming Calls</u>	1403.99	553.66	2.54 ***
OC	<u>Outgoing Calls</u>	-144.29	323.00	-0.45
CP	<u>Officer NOAs</u>	380.52	239.04	1.59
LLC	<u>LLC Member NOAs</u>	-207.80	2401.10	-0.09
L	<u>Liens</u>	279.58	1389.27	0.20
FN	<u>Final Notice</u>	666.46	1151.51	0.58
LV	<u>Levies</u>	249.47	1633.07	0.15
TA	<u>TAs</u>	-218.17	416.05	-0.52
AJ	<u>AJs</u>	-1124.25	924.11	-1.22
ROF	<u>Refund Offset Letters</u>	-2181.22	2283.31	-0.96
PRO	<u>Protests</u>	6230.77	22784.57	0.27
TE	<u>Total Employees</u>	-1799.66	81442.69	-0.02
AR	<u>Receivables</u>	-0.01	0.02	-0.62
Cs	<u>Cases</u>	173.67	144.46	1.20

<u>Number of observations</u>	36.00
<u>R- Squared</u>	0.59
<u>F</u>	1.94

\*\*\*p<0.01, \*\*p<0.05