

Massachusetts Tax Audits in a Time of Crisis

Boston Bar Association

February 5, 2008

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Outline

(Continued)

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Part I: The Massachusetts Structural Deficit – An Overview

The Massachusetts Structural Deficit

- The gap between our desires and our tax collections: About \$1.5 Billion per year.
- Political Sources of the Deficit
- Economic Sources of the Deficit
- Economic Limitations on Bridging the Deficit

Our Desires

- **Universal Health Care**

- “The subsidized insurance program at the heart of the state's healthcare initiative is expected to roughly double in size and expense over the next three years – an unexpected level of growth that could cost state taxpayers hundreds of million of dollars or force the state to scale back its ambitions.”

- Boston Globe, Front Page, Above the Fold, Sunday, February 3, 2008

Our Desires

(Continued)

- **“Free” Nursing Home Care for Seniors**
 - Our residents want to permit parents to transfer their wealth to their children.
 - They want our society to pay for the parents’ nursing home costs.
- **Safe Bridges and Roads**
 - The Longfellow Bridge

Our Desires

(Continued)

- **Extraordinary Educational Opportunities for our Children**
 - Newton North High School: Pushing \$200 million
 - Newton's Two Political Disconnects – High School Advocates and Designers are not responsible for:
 - Determining the overall cost; or
 - Deciding how to pay for the high school.
- Listing is NOT exhaustive

Political Limitations on Taxation

- **Ballot Initiative:** Repeal the Individual Income Tax
- **Income Taxes:**
 - Flat Income Tax Rates – Modified a bit by the exemptions.
- **Real Estate Taxes: Prop 2&1/2**
 - Real Estate Taxes can only go up by 2.5% per year.
 - Inflation increases at a faster rate.
 - Need for Overrides after 30 years of inflation

Economic Sources of the Structural Deficit

- **Economic Transition**
 - **From** an industrial economy based on manufacturing
 - **To** a post-industrial economy based on thought leadership
- **Loss of 100,000 jobs since the last recession.**
- **Loss of population.**

Effect of Job Losses on our Tax Base

- 100,000 jobs results in a deficit of at least \$670 million* in lost taxes:

• Income taxes	\$2,400 per person*
• Unemployment taxes	700
• Sales Taxes	1,600
• Real Estate Taxes	<u>2,000</u>
Total Lost Taxes	\$6,700 per person

*Assumption: Average job pays \$60,000 per year

Very rough estimate

Economic Limitations on Taxation

- **Too great a levy prevents job growth**
 - Analogy to “over-fishing”
 - Minimum Investment in a professional service job \$50,000*
 - Build Out
 - Furniture and Equipment
 - Work in Process
 - Account Receivables

*Based on the experience of M. Robinson & Company, P.C.

Part II: State Government Responses to the Massachusetts Structural Deficit – An Overview

State Government Responses to the Massachusetts Structural Deficit

- **Enforce and collect all taxes, fees and fines**
 - “Enhanced” Ticketing on the Massachusetts Turnpike
 - “Enhanced” Enforcement of Tobin Bridge Tolls
 - “Enhanced” Collection of Logan Airport Fees
- **Additional Computerization to Achieve Greater Efficiencies**

State Government Responses to the Massachusetts Structural Deficit (Continued)

- **Governor's Proposal:** Accelerate the failure-to-pay penalty from .5% per month to 1% per month
 - Additional Revenue Estimate: \$12 million
- **Three Tax Audit Initiatives**

Audit Initiatives*

- Worker Classification Enforcement Audits
- Discover Tax Audits
- DOR Hiring Additional 87 Auditors
 - Roughly doubles the DOR Audit Corps

* DOR has given out very little information regarding these audit initiatives.

Worker Misclassification Audits

- In coordination with:
 - The Attorney General
 - The Department of Unemployment Assistance
- Modeled on a program of the State of New York.

Worker Misclassification Audits (Continued)

- According to a Seyfarth Shaw Memorandum on New York State:
 - “[C]omments by Governor Spitzer and others make clear that the Task Force’s primary focus will be identifying, investigating and prosecuting possible violations by employers, and that education and outreach are secondary goals at best.” (Emphasis added)

Seyfarth Shaw LLP One Minute® Memo September 2007

How Misclassification Audit Targets Are Chosen

According to a DUA supervisor:

- DUA conducts about 2,000 audits per year.
- Audit targets are chosen:
 - By Industry
 - By Geographic Location
- Average time per audit is about 6 hours (assuming no issues).

Goals of Misclassification Audits

- Confirming that withholding taxes relating to employees are, in fact, withheld and paid over.
- Confirming that all income paid to workers is, in fact, reported by them.
- How audit goals are achieved? By Reviewing:
 - Detailed Payroll Records
 - Cash Disbursements Journal
 - General Ledger
 - Petty Cash

Discover Tax Audit Program

- Discover Tax Identifies audit targets.
- Cost: \$6 million
- Additional Revenues to Date: Over \$500 million
 - Businesses \$250 million
 - Individuals 250 million

How Discover Tax Works

- Discover Tax uses **data mining** and compares information in over 80 data bases.
- Examples:
 - **Individuals:** An individual does not report unemployment insurance income on his/her Massachusetts income tax return.
 - **Businesses:** **Gross receipts** for income tax purposes do not equal **gross receipts** for sales tax purposes.

DOR Hires 87 New Auditors

- Announced on January 31, 2008 by Navjeet Bal, the new Commissioner of Revenue, at the AIM State Tax Committee
- This may roughly double the number of auditors.
- DOR Audits presently bring in about \$1 Billion per year, according to former Commissioner, Henry Dormitzer.
- Is State Government looking to double the amount of audit collections?
- Massachusetts State Government has decided to exploit Discover Tax

Part III: The Massachusetts Department of Revenue – An Overview

What the DOR Does

- Child Support Collections
- Assisting Cities and Towns
- Enforcing the Healthcare Mandate
- General Revenue Collection
- Auditing, Appeals, Collection, Litigation, and Administration

Allocation of DOR Personnel

• Child Support Collections	750
• Assisting Cities and Towns	75
• Enforcing the Healthcare Mandate	0
• General Revenue Collection	600*
• Auditing, Appeals, Collection, Litigation, and Administration	<u>775</u>
Total Employees	2,200*

* Add about 100 temporary employees during tax season

Where the DOR Achieves Outstanding Results

- **Collecting the Revenue**
 - Collection Rate per Employee: About \$40 million
 - Based on an estimate of 650 employees involved in the actual collection process.
- **Verifying and Issuing Refund Checks – 3 to 4 days for electronic returns.**
- **Customer Service Bureau**

Computers are Source of Efficiencies

- Computer Strategy followed for past 20 years
 - Mitchell Adams
 - Fred Laskey
 - Alan LeBovidge
- DOR is looking at a new computer initiative
 - Massachusetts will float bonds to pay for computers

Part IV: Representing Taxpayers

What DOR Auditors Do

- Once a business is targeted by Discover Tax, the auditor compares Cash Receipts for bank purposes with:
 - Cash receipts for the income tax portion of the excise and for income tax purposes.
 - Cash receipts for sales tax purposes.
 - Cash receipts for meals tax purposes.
- If a business' accountants have exercised reasonable care, the DOR auditors will find it easy to reconcile these amounts.
- If the tax accounting is substandard, the business will not be able to easily reconcile its cash receipts to its tax returns.

How DOR Audits Marginal Cash-Based Businesses with Inadequate Records

- Many “cash” businesses have substantial credit card and debit card receipts.
- The ratio of credit card and debit card receipts to total receipts can be roughly estimated using industry criteria.
- Total Receipts can thus be roughly estimated.

How DOR Audits Marginal Cash-Based Businesses (Continued)

- Once cash receipts are estimated, it is easy to audit the taxes based on the businesses cash receipts:
 - Income tax portion of the business excise
 - Sales taxes
 - Meals taxes

How Burden of Proof is Used Against Businesses

- There is no attempt to determine the “correct” tax.
- Auditors choose the combination of income, sales and meals tax that produces **the highest possible tax.**
- Businesses are given 30 days to reconstruct their records or take an appeal.

Reconstructing the Accounting Records/Filing Amended Returns

- Sometimes the best approach is to reconstruct the accounting records.
- It might then be appropriate to file amended U.S. and Massachusetts returns.

Responding to the Notice of Intent to Assess (NIA):

- **Take an Appeal:**
 - Appeals are best when there are issues of law.
 - Appeals are inefficient when the issues are factual and the auditor simply needs to review the additional information provided by the taxpayer and its advisors.
- **Request an Extension:**
 - Use the time to reconstruct accounting records and (perhaps) file amended returns.

Extending the NIA Period

- The NIA is a notice of an intention to assess.
- The 30-day NIA period can be extended by agreement of the taxpayer and the DOR.
- The NIA period should be extended if the issue is factual and the taxpayer simply needs time to reconstruct their records and perhaps to file amended returns.

Tax Audit Assessments May Destabilize Businesses and Cost Jobs

- A service business in Massachusetts must make a minimum investment of \$50,000 per job.
- The money is used for:
 - Leasehold Improvements (\$15,000 - \$20,000)
 - Furniture and Equipment (\$5,000)
 - Accounts Receivable and Work in Process (\$25,000 - \$30,000)

Tax Audit Assessments May Destabilize Businesses and Cost Jobs (Continued)

- If \$50,000 is unexpectedly taken from a small business it becomes difficult to sustain the job.
- Potential job losses amount to 5,000 ($\$250 \text{ million taken from Businesses} / \$50,000 \text{ per job}$)

Discover Tax Payments vs. SBA Loans Stimulus

- Discover Tax has already taken more than \$500 million from Massachusetts businesses and individuals.
- The \$500 million should be compared to the stimulus generated by \$761 million in SBA loans extended to smaller Massachusetts businesses over the past three fiscal years ending September 30, 2007.

The Critical Role of Substandard Tax Accounting

- The root cause to Discover Tax problems is substandard accounting. This is the failure to reconcile:
 - **Cash Receipts** to:
 - **Cash receipts** for the income tax portion of the excise and for income tax purposes.
 - **Cash receipts** for sales tax purposes.
 - Cash receipts for meals tax purposes
 - **Payroll Expense** per the General Ledger to:
 - **Payroll expense** reported on the income tax returns
 - **Payroll expense** reported on the U.S. and Massachusetts payroll tax returns.

The Role of Substandard Tax Accounting (Continued)

- Substandard Accounting was once hard to detect.
- Thanks to Discover Tax, substandard accounting is as easy to see as a deer frozen in a search light.
- And the affected business is as easy to kill as the deer.

The Root Causes of Substandard Tax Accounting

- **An anemic Massachusetts economy** with many small marginal businesses that cannot afford to pay accountants enough money to do a strong professional job.
- **Ignorance of Tax Accounting**
 - Some smaller business owners are in business because they lack the education and polish needed to hold down jobs.
 - They never understood the necessity of solid tax accounting.

The Root Causes of Substandard Tax Accounting (Continued)

- **Ignorance of the Law**

- A client told me he didn't know that bottled water was subject to the meals tax when sold in his sandwich shop.
- Therefore, he didn't collect the tax on bottled water.

The Root Causes of Substandard Tax Accounting (Continued)

- **Ignorance of the Exposure**

- Many marginal businesses have told DOR Appeals Officers that they simply didn't understand the magnitude of the problem.
- **Example:** A mistake of as little as \$50 a day for a small grocerette will amount to close to \$85,000 in liability in sales or meals taxes after three years.

The Root Causes of Substandard Tax Accounting (Continued)

- **Prior Lack of Tax Enforcement**
 - Some businesses will take a chance since the laws were not effectively enforced in the past.
 - Many businesses simply did not understand the dimensions of their exposure. (See above example.)

The Root Causes of Substandard Tax Accounting (Continued)

- **Unregulated tax return preparers**
 - The Massachusetts Board of Public Accountancy regulates accountants who prepare financial statements.
 - The Massachusetts Board does **not** regulate the bookkeepers who prepare routine business returns:
 - Income tax returns
 - Sales tax returns
 - Meals tax returns
 - Payroll tax returns.

Department of Unemployment Assistance Misclassification Audits

- I do not yet have experience with DUA misclassification audits.
- I have my first DUA audit later this week.
- I hope to be invited back to update this group after I have something to say.

Part V: Needed Reforms

Sub Part A: Regulating Tax Return Preparation

Sub Part B: Helping Marginal Businesses Survive

Sub Part A: Regulating Tax Return Preparation and Educating Business Owners

Root Causes of Debilitating Tax Liabilities

- The **root causes** of debilitating tax liabilities are:
 - Substandard tax accounting
 - Ignorance of the law
 - Lax Enforcement
- **Substandard tax accounting** can be resolved through the regulation of tax return preparers.
- **Ignorance of the law** can be resolved through the education and regulation of business owners.
- **Lax Enforcement** is likely to no longer be an issue.

Regulating Tax Return Preparers

- The Massachusetts Board of Public Accountancy must enforce minimal standards for all who prepare Massachusetts tax returns for hire, including bookkeepers.
 - The preparer must reconcile **cash receipts** per the income tax returns with **cash receipts** per the sales and meals tax returns.
 - The preparer must reconcile **payroll** per the income tax returns with payroll per the **payroll** tax returns.
- If necessary, new legislation should be enacted.

Regulating Tax Return Preparers (Continued)

- The preparer must keep the reconciliation workpapers for a minimum of three years.
- The preparer may not sign a tax return unless the preparer has prepared and kept reconciliation workpapers and provided a copy of the reconciliation to the business owner.

Regulating Business Owners

- Every business owner should take a test – similar to a driver’s license test. The test will assess
 - The business owner’s knowledge of his/her obligations to pay income, sales, use, meals, and payroll taxes; and
 - The business owner’s ability to prepare the appropriate tax forms.
- Business owners who “waive” or “flunk” the test will be required to hire bookkeepers regulated by the Massachusetts Board of Public Accountancy to prepare their business’ tax returns.

Educating Business Owners

- Business owners should be educated as to their responsibilities by:
 - Their respective trade associations and
 - The DOR

Sub Part B: Helping Marginal Businesses Survive

Micro Loans

- Encourage banks to provide micro loans (up to \$100,000) to businesses so they can pay the tax liability.
 - The business and its owners must be credit worthy.
 - Businesses and their owners must pledge sufficient assets to provide a reasonable prospect to repayment.
 - Loans would be guaranteed by the Commonwealth of Massachusetts.

Temporary Amnesty on Interest and Penalties

- This is an amnesty to permit delinquent businesses to “come clean”.
- There was such an amnesty just before Discover Tax was implemented.
 - Most taxpayers did not come forward.
 - In light Discover Tax’s effectiveness, the Amnesty offer should be renewed.

Reduce Failure-to-Pay Penalties In Exchange for Cooperation

- The failure to pay penalty can add as much as 25 percent to the tax liability.
- Allow taxpayers a one-time opportunity, if audited, to clean up their own messes and file amended United States and Massachusetts income tax returns.
- If these returns are completed and filed in good faith and in a timely manner, the DOR will waive the failure to pay penalty.

Reduce Failure-to-Pay Penalties In Exchange for Cooperation (continued)

- The DOR benefits since the same number of auditors can audit perhaps 50 percent more businesses.

Avoiding Destabilizing Tax Lien Filings

- Massachusetts currently publishes tax liens against a business that does not pay the taxes due.
- Liens are filed even if the business has entered into an installment payment agreement and is current in its payments.
- Liens are published in newspapers such as the Boston Business Journal.

Avoiding Destabilizing Tax Lien Filings (Continued)

- **The lien filing can create questions by:**
 - **Suppliers** – who may cut off credit.
 - **Customers** – who may choose to obtain a more financially stable seller of goods and services.
 - **Employees** – who may choose to obtain more financially stable employer.
- Liens should be filed only as a **last resort** where the business and its owners are unable to provide sufficient collateral to secure the debt.

Offers in Final Settlement

- Every operating business has “good will value”.
- Rashi, a medieval Bible commentator, once likened a person in financial trouble to a donkey staggering under its load.
 - While the donkey is still on its feet, one person can adjust the load.
 - If the donkey stumbles and falls, even five people cannot raise the fallen donkey.

Offers in Final Settlement (Continued)

- Here, too, if a troubled business is able to make current tax payments but is unable to pay the prior payments, consideration should be made to forgiving some of the indebtedness so the business and its jobs can survive.
- Current DOR policy is to reject the Offer in Final Settlement unless the business is dead!
- Current DOR policy should be reexamined.

Offers in Final Settlement (Continued)

- No Offer in Final Settlement should be rejected merely because the death of the business and its jobs provides greater immediate revenue to the Commonwealth of Massachusetts.

Part VI: The Challenge Facing Massachusetts: Renewal or Decline

Societies Must Renew Themselves or Perish

- Massachusetts has not regained about 100,000 lost since the last recession.
- Massachusetts has consistently lost population for several years.
- Lessons From Economic History
 - **Collapse: How Societies Choose to Fail or Succeed** – Jared Diamond
 - **Reflections in Bullough's Pond** – Diana Muir.

Due Process of Law is Not Enough to Prevent Economic Collapse

- The Great Depression
- The Current Subprime Mortgage Crisis
 - People accepted mortgages they knew they could not pay.
 - If nothing is done:
 - People will lose their homes.
 - Cities and Towns will lose real estate taxes
 - Neighborhoods will become destabilized.
- Economic collapse, bankruptcy, abandoned homes, and destabilized neighborhoods are completely consistent with due process of law and the equal protection of the laws.

Political and Economic Freedom Are Not Sufficient to Prevent Economic Collapse

- The “Tragedy of the Commons”
 - Fishermen compete against each other to catch as many fish as possible.
 - There is no incentive to prevent over fishing.
 - If one fisherman doesn’t get the last remaining fish, the next one will.
 - Thus, enlightened self-interest (Adam Smith’s “unseen hand”) without social regulation leads directly to the collapse of fish stocks.

The Federal Reserve is not Able, by Itself, to Prevent An Economic Collapse

- The world is too complex and interdependent.
- The United States does not control the world economy.
- Over the past 30 years we have significantly inflated our currency and significantly devalued our dollar. This is not a long-term recipe for an enduring society.

Pillars for an Enduring Society

“An enduring society is founded on three pillars:
On justice, on truth and on peace.”

- Rabban Shim'on Ben Gamliel (Active 80 – 116 C.E.)
- Pirkei Avot, Chapter 1, Mishnah 18.

- **Justice:** This includes due process of law, the equal protection of the laws and fundamental rules of fairness.
- **Truth:** This includes the courage to face up to inconvenient facts.
- **Peace:** This includes the active pursuit of social harmony and compromise by all sectors of society.

Justice

- Justice includes a commitment to due process of law and the equal protection of the laws.

Truth

- We must confront the truth
 - Our existing businesses generate wealth. They are a valuable part of our social capital and the source of our jobs.
 - Our existing businesses – even the marginal ones – must not be unnecessarily sacrificed.
 - There are economic limits to how much money government can extract from a business without endangering it and its jobs.
 - I sense that we might be reaching those limits with Discover Tax Audits.

Truth

(Continued)

- The issue is NOT whether the business owes the money. Let's assume it does.
- The issue is whether the business can pay up at once and still survive.
- We must not allow short sighted “overfishing” that destroys our businesses – even if the “overfishing” is done in full conformity with due process of law and the equal protection of the laws.

Peace: The Active Pursuit of Compromise and Social Harmony

We must also actively pursue compromise and social harmony.

Specifically, we must craft solutions that are:

- **Fair** to the people of Massachusetts who are counting on the taxes to run our society.
- **Fair** to those businesses who properly and timely accounted for and paid over their taxes.

Peace: The Active Pursuit of Compromise and Social Harmony (Continued)

- **Fair** to the business owners who may have failed to understand the impact of substandard accounting on their businesses.
- **Fair** to the employees and families of affected businesses.
- **Fair** to the accountants and bookkeepers who prepared substandard tax returns.

Conclusions

- Ignorance, lax enforcement, risk taking and substandard accounting have created a tax crisis that jeopardizes the survival of many marginal Massachusetts businesses and the jobs they support.
- The suggestions (in Part V) for dealing with this crisis should be debated to see if they meet the criteria of justice, truth and social harmony, which are the benchmarks of an enduring society.
- If so, these suggestions should be promptly implemented.

Conclusions

(Continued)

- I am not trying to preach.
 - Ultimately, the issue is not how to achieve a moral society.
 - The issue is how to achieve an enduring society.
- It just so happens that an enduring society is also a moral society.

Conclusions

(Continued)

- This is not surprising.
 - We are all the children of those who have successfully avoided social collapse for 5,000 years.
 - Those who perished did not leave children.
 - As children of the survivors, we share an instinctive perception of what is required for a society to endure. We call this intuitive perception morality.
 - It is therefore not surprising when we discover that the foundations of an enduring society are also the foundations of a moral society.

The End