

**PRESENTATION OF THE  
OFFICE OF TAX AND REVENUE**

**Before the  
D.C. Tax Revision Commission**

**The Honorable Anthony Williams, Chairman**

**November 4, 2013, 3:00 p.m.  
1101 4<sup>th</sup> Street, SW – Room W250**



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Good afternoon Mr. Chairman and members of the Commission, I am Stephen Cordi, Deputy Chief Financial Officer for the Office of Tax and Revenue. I very much appreciate the opportunity to address the Commission today on behalf of the Office of Tax and Revenue.

Gerry Widdicombe was good enough to provide me with a suggested list of topics to address. When we went over them a few weeks ago, we agreed that covering all of them would take many more hours than has been allotted. For that reason, I am not going to try to get to them all, but can respond to any questions which you may have.

The Commission has engaged Linda Tanton to do a report on the operations of OTR, and you will hear from her shortly. I've decided not to replicate her remarks on the day to day operations of the agency.

What I would like to do this afternoon is speak more generally to major themes affecting the agency, to agency initiatives and to administrative aspects of several of the tax policy options under consideration by the Commission.

### **Internal Controls**

For OTR, the 2007 tax scandal revealed that internal controls over manually issued refunds were weak or non-existent. Creating, maintaining and improving internal controls have been among our most important tasks since then. We have had a lot of help from internal and external auditors and from the CFO's Chief Risk Officer.

For manual refunds, at Dr. Gandhi's express direction, we adopted comprehensive procedures, augmented documentation requirements, provided for tiered reviews, and instituted a back-end check through a Refund Control Unit created in our Revenue Accounting Administration.

Internal controls within the Integrated Tax System turned out to be weak as well. The system was designed with some functionality screens which permitted users to both authorize and approve transactions, users had incompatible

authorizations and OTR was not effective in updating user rights when employees moved from department to department.

We've addressed these problems and more. The institution of internal controls is not a one-time exercise. It is an ongoing process of review, remediation and checking, followed by more reviews, remediation and checking.

We, of course, have no way of knowing what mischief we may have prevented through enhanced internal controls. We do know that the controls identified two separate employee schemes which were being used before the tax scandal broke when those employees tried to resume them afterwards.

The institution of effective internal controls requires multiple reviews and approvals of transactions and additional work with taxpayers, in other words a whole lot of additional work. The process would have been difficult in normal times. Unfortunately, most of the work had to be done in the face of a sharp economic downturn. Between FY 2009 and FY 2012, OTR lost approximately 100 of its 550 authorized positions. We've regained some of those positions in the last two budget cycles, but remain 60 positions short of our 2009 staffing level. Unfortunately, there has been some degradation of service and taxpayers have noticed that the pace of issuing refunds has slowed and call wait times have increased.

### **External Controls**

Not only did internal controls require improvement, controls of external refund fraud needed attention. In 2008, our fraud detection program was largely manual, dependent upon reviews of paper returns, taxpayer audits and filters for suspicious circumstances, such as withholding tax claims out of proportion to reported income. By 2009, we instituted an automated data warehouse check of refund returns to make sure that the claimant was a real person identifiable as being in the District. The data warehouse contains such things as employer w-2 information, unemployment wage reports, driver's licenses and vehicle registrations. This has been a fairly effective check on refund fraud based upon fake social security numbers and the use of social security numbers of persons with no actual District attachments.

We've tried a number of filters to identify fraudulent returns filed with social security numbers of persons who happened to have had a DC connection. Some have swept too broadly and turned up too many false positives. Others have worked well. Last year, for the first time, we have been blocking refunds for taxpayers listed on the Social Security Death Index, a procedure the IRS has had in effect for some time.

This year, we will pass refunds claims against our employer w-2 file, halting for review returns for which no w-2 information is being reported by the employer or for which no employer is on our file and adjusting returns where the employee has reported different wages or different withholding than is being reported by the employer. This check was made possible by a change in District law several years ago which requires employers to file their w-2 reports with us by January 31 of each year and electronically if 25 or more employees are being reported.

The other thing which we are doing for the upcoming filing season is to request taxpayers to provide us with their dates of birth. This information should be of considerable benefit to the Council and to our revenue estimators as policy-makers seem increasingly to want to condition tax benefits on the basis of attaining a certain age. Right now, all that we know about taxpayers is whether or not they claim to be over 65 years of age. The other benefit to this is that, down the road, it is another data element that will make identity theft refund fraud more difficult.

### **Integrated Tax System**

The most pressing issue currently faced by OTR is the necessity of replacing its Accenture Tax Administration System (TAS). TAS was implemented in early 2001, replacing a hodge-podge of stovepipe systems for separate taxes. It has served the District well, but it has reached the end of its useful life. It is a COBOL system expensive to maintain; its noticing and case flow systems are rudimentary, and it is not really designed for an effective web presence. While we could throw more money at these and other issues, we could not get much of that work done before we could have a modern integrated tax system in place.

OTR went through an elaborate request for information (RFI) process to see what was available in the market and hired an outside consultant to assist us in

developing business user requirements. We have issued a Request for Proposals (RFP) and are now in the process of evaluating responses. Members of the selection board are scheduling site visits of the systems in place in other jurisdictions for this month. We hope to have evaluations ready for the new chief financial officer when he takes office. Many of the helpful suggestions being made today by Ms. Tanton can, as a practical matter, best be accomplished in a new system.

### **Tax Collection and Debt Recovery through Offset**

By far, the most effective means of collecting tax and non-tax debt is to do so through offset and not through enforced collection methods such as the filing of tax liens, bank attachments and wage garnishments. Here, we have made good progress in recent years. Historically, OTR offset its own refunds to satisfy unpaid tax, child support and unemployment insurance obligations and participated in the IRS refund offset whereby federal income tax refunds were captured to satisfy DC income tax debts.

Two years ago, we implemented a DC vendor offset program, whereby any payments which DC makes to contractors and others is offset to pay DC taxes, a program that produces about \$1 million in collections per year directly and much more indirectly. A year ago, we instituted a reciprocal refund offset program with the Maryland Comptroller's Office whereby Maryland refunds are captured to pay delinquent DC taxes and vice versa, a program that produces about \$1.5 million per year. This year, we joined the federal vendor offset program run by the U.S. Treasury whereby federal vendor payments are offset to pay delinquent DC taxes and vice versa. So far this year, we have intercepted in excess of \$10 million in federal vendor payments to satisfy DC tax debts, the highest amount for any jurisdiction in the program.

Also this year, the Council authorized OTR to intercept DC income tax refunds to pay outstanding parking ticket liabilities of the Department of Motor Vehicles. So far this year, we have intercepted more than \$3.5 million in DC income tax refunds from almost 13,000 returns. The program really didn't get started this year until well into February, missing the early peak of the tax filing season. Getting started at the outset of next filing season should result in collections approaching \$5 million.

OTR continues to work on expanding these programs. There remain practical opportunities to do so.

### **The Marketplace Fairness Act**

As the Commission knows, there have been positive developments with regard to the remote collection of sales and use taxes. Historically, the states and the District have been prohibited from requiring remote sellers without substantial physical presence to collect our sales and use taxes in the absence of congressional authorization. Much to the surprise of many, just that authorization was passed by the Senate this spring in the form of S.743. S.743 would authorize the remote collection of the tax with relatively few burdens imposed up the states. We will need to be able to provide a central registration system which can probably be accomplished by making use of the existing central registration system of the Streamlined Sales Tax Project, and we need to provide software free of charge that calculates the tax and files returns. We believe that software can be provided through existing certified software providers of the Streamlined Sales Tax Project, at some presently unknown cost to the District.

The legislation has been transmitted to the House of Representatives and referred to the House Judiciary committee, chaired by Virginia representative Robert Goodlatte. Mr. Goodlatte is not known to be friendly to authorizing the remote collection of the tax. He has released what he calls his "Basic Principles on Remote Sales Tax Collection Authority," which are very general in nature and give little clue to what he actually intends to do. My view is that the most likely outcome is that the Judiciary Committee will do nothing with the bill. The next most likely outcome is that the legislation will be significantly weakened and passed out with a series of restrictions on the ability of the states to tax which have been kicking around in congress for some time, including, in particular, the Business Activity Tax Simplification Act, a poison pill intended to kill state corporate income taxation outright. The least likely, but nonetheless possible, outcome is a bill that the states and the District could actually use to obtain remote collection of sales and uses taxes.

## **Sales Taxation of Hotel Intermediaries**

For more than a decade, states, cities and counties have been litigating with hotel intermediaries on the issue of whether those entities, with familiar names like Expedia, Priceline and Hotels.com, should be remitting hotel occupancy taxes on the portion of the charges paid by customers which are retained by them. Typically, customers come to web sites maintained by the hotel intermediaries, contract and pay for hotel accommodations, following which a lesser sum, plus the sales tax on the lesser sum is directed to the hotels. Those hotels then remit the amount of the tax with their local sales tax or hotel tax return. Local taxing authorities often take the position that the amounts that the hotel intermediaries retain as their fees are as much of the price for the hotel rooms as the amounts actually remitted to the hotels.

Over the years, the hotel intermediaries have won more cases than they have lost, often winning on technical issues such as whether or not they fit within the definition of an “innkeeper” in antique taxing statutes. Where they have lost in small jurisdictions, they have reacted, not by commencing to collect the taxes, but rather by cutting off hotels within the tax jurisdiction and offering only hotels outside the taxing jurisdiction.

OTR felt for some time that our sales tax statute, which is where the hotel tax is imposed, was clear on the proposition that the tax was due on the entire consideration for the transaction. We were unable to interest the Attorney General’s Office in pursuing the matter itself or authorizing the use of outside counsel until Irv Nathan took office as DC’s Attorney General. He took an immediate personal interest in the matter and directed skilled members of his staff to pursue the collection of these taxes by filing suit in Superior Court.

The Attorney General has won an important early victory when the defendants’ motion for summary judgment was denied. The case is by no means over, though, and is likely to have to be resolved in the DC Court of Appeals. The prospects for a recovery in the \$60 million range are good, as are the prospects for ongoing revenues thereafter.

## **Tax Policy Options Presented to the Commission**

Staff of the Commission, Gerry Widdicombe, Steve Rosenthal and Richard Auxier has briefed me on the policy options being considered by the Commission. They have been good enough to alert the Commission to the very few issues which entail any administrative issues at all. Overwhelmingly, the policy options presented to the Commission present no significant issues of administration. Needless to say, OTR has no views on the policy issues. That said, I would like to touch upon those few policy options which present administrative issues. I will address them in the order in which they appear in the Deliberations Draft of September 26, 2013.

### **#3 – Assert click-through nexus**

This is a suggestion that the District adopt an “Amazon” type statute similar to the one adopted several years ago by New York which asserted nexus on the basis of New York websites providing “click-through” access to a remote vendor’s web site and being compensated for resulting sales. When this legislation was first enacted, Amazon began collecting the tax in New York while litigating the validity of the law.

In every subsequent enactment of similar legislation by a state, Amazon reacted by terminating the local websites from its click-through program and not collecting the tax. It is a virtual certainty that it would do the same were the District to enact such legislation, the result being that District businesses would lose revenue and no additional sales taxes would be collected.

The situation took a turn for the worse several weeks ago when the Illinois Supreme Court ruled that that’s state’s click-through nexus law was prohibited by the Internet Tax Freedom Act as discriminating against online sales.

OTR would naturally like to avoid being sent on the wild goose chase that this legislation would entail.



#### **#4 – Add use tax line to the personal income tax return**

This is a program that exists in a number of income tax states with sales and use tax statutes. The level of taxpayer response typically hovers around 1% reporting anything at all on the line.

Whether the District could collect enough to cover its direct and indirect costs is problematic, but even if we were fortunate enough that our expenses were only half of collections, it's a wasteful use of taxpayer dollars.

Taxpayers inherently know that there is no practical way for the government to enforce a use tax reporting requirement on income tax returns. That's why compliance is so low everywhere else. Taxpayers cannot imagine that government officials would actually try to examine their credit card bills and checkbooks to look for unpaid use taxes and, frankly, neither can I.

By definition, almost everyone owes some use tax, if only on a magazine subscription or book from Amazon, so a compliance level of 1% suggests that we would convert 99% of our income tax returns, now overwhelmingly accurate and honest, into inaccurate and fraudulent. That can only bring the government into disrepute, and no one can convince me that it is good tax administration.

When I testified on similar legislation in the Maryland Senate Budget and Taxation Committee some years ago for the Maryland Comptroller, I noted that the only taxpayers who would write anything at all on a use tax line were elected officials, people with licenses to protect and the pathologically honest; the other 99% of us would report nothing. Maryland has wisely not enacted any such requirement.

#### **#31 – Replace BFT and UBT tax w/an expanded gross receipts tax**

The previous tax revision commission recommended replacing the District's franchise taxes with an expanded gross receipts tax. At the time that recommendation was made, the District's franchise taxes were rapidly becoming almost voluntary as a result of tax planning in the form of intangible holding companies, finance subsidiaries and garden variety transfer pricing. The gross receipts tax recommendation was not adopted, but the District did, after a few years, adopt add-back legislation to reduce losses from intangible holding

companies and finance subsidiaries, and, much more importantly, adopted combined reporting beginning in tax year 2011.

Combined reporting, which is similar to consolidated filing at the federal level, eliminates inter-company transactions and the tax planning opportunities thereby provided. OTR is only now processing the returns from the second year of combined reporting. It is a little too early to have reached any definitive conclusions on the effectiveness of combined reporting in the District, but the early signs are hopeful.

The implementation of combined reporting was a significant undertaking for OTR and the District's business taxpayers. At this point, needless to say, OTR would like to avoid another disruptive change in business taxation, in the absence of a pressing reason for such a change.

#### **#46 – Split Property Tax – land and buildings**

OTR does provide separate values for land and improvements as part of its real property assessment process. These are really just estimates, however. Properties are in fact valued on a combined basis without regard to the components.

There are simply not enough arms-length sales of true vacant property in the District to provide any reliable basis for assessing land separately from buildings. It is difficult enough for OTR to produce accurate values for improved properties in the aggregate without the additional burden of having to produce defensible values for the components separately, with little in the way of market data for land sales.

If legislation were enacted providing for differential tax rates for land and buildings, we foresee a sharp jump in appeals for properties, correctly assessed in the aggregate, contesting the unknowable. Whatever the theoretical benefits of separately assessing land and buildings may be, they are assuredly outweighed by the practical problems of doing so.

Thank you, Mr. Chairman, for the opportunity to address the Commission this afternoon.

