MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE

COLLECTION OF DELINQUENT STATE TAXES

DEPARTMENT OF TREASURY

May 2008

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

271-0153-07

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

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REPORT SUMMARY

Performance Audit

Collection of Delinquent State Taxes

Department of Treasury

Report Number:
271-0153-07

Released:
May 2008

Under the authority of Act 122, P.A. 1941, as amended, the Collection Division, Department of Treasury, is responsible for pursuing the collection of delinquent State taxes identified by the other divisions within the Department.

Audit Objective:
To assess the effectiveness of the Department's efforts to pursue methods of collecting identified delinquent State taxes.

Audit Conclusion:
We concluded that the Department's efforts were effective in pursuing methods of collecting identified delinquent State taxes. However, our assessment disclosed two reportable conditions (Findings 1 and 2).

Reportable Conditions:
The Department had not collected and analyzed data to determine and implement the most effective and efficient use of liens to help protect the security interest of the State and to help collect delinquent State taxes (Finding 1).

The Department should perform a cost-benefit analysis of allowing taxpayers the ability to use credit cards to pay State taxes. In addition, if the Department's analysis supports the use of credit cards as a method of paying State taxes, the Department should seek amendatory legislation to authorize the use of credit cards as a payment option. (Finding 2)

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Agency Response:
Our audit report contains 2 findings and 3 corresponding recommendations. The Department's preliminary response indicates that it partially agrees with 1 recommendation and agrees with 2 recommendations.

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AUDITOR GENERAL

May 30, 2008

Mr. Robert J. Kleine
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

This is our report on the performance audit of the Collection of Delinquent State Taxes, Department of Treasury.

This report contains our report summary; description of agency; audit objective, scope, and methodology and agency responses and prior audit follow-up; comment, findings, recommendations, and agency preliminary responses; four exhibits, presented as supplemental information; and a glossary of acronyms and terms.

The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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COLLECTION OF DELINQUENT STATE TAXES
DEPARTMENT OF TREASURY

GLOSSARY

Description of Agency

Under the authority of Act 122, P.A. 1941, as amended, the Collection Division, Department of Treasury, is responsible for pursuing the collection of delinquent State taxes identified by the other divisions within the Department.

Division operations are administered through a central office in Lansing and seven district offices located throughout the State. The Division maintains delinquent tax account and assessment* data on its State Treasury Accounts Receivable (STAR) system. The Department of Attorney General provides legal assistance for the collection of certain accounts.

The Division uses various techniques to collect amounts due the State. These techniques include letters, phone calls, installment agreements, State income tax refund offsets, vendor payment offsets, wage and/or bank levies, tax warrants (property seizure and sale), and tax liens. The Division also contracts with a private collection agency to provide collection services for accounts referred by the Division. The collection agency receives a commission of the delinquent taxes received by the State as a result of its collection efforts. For fiscal year 2005-06, the Division reported that commissions paid to the collection agency totaled $15.8 million.

As of May 31, 2007, Division records indicated that there were approximately 334,000 delinquent tax accounts with accumulated tax, penalty, and interest balances totaling $2.5 billion. The delinquent tax accounts by collection status as of this date were as follows:

Collection Status	Number of Accounts	Total Dollar Value of Accounts
Active collectible	263,664	$ 1,422,510,667
Intent to assess	28,090	119,826,202
In correspondence review	2,964	22,616,679
In appeal	805	221,131,981
In litigation	1,481	37,323,052
Currently not collectible	2,458	36,996,906
In bankruptcy	18,493	353,688,275
Pending write-off	16,475	312,901,441
Total	334,430	$ 2,526,995,203

* *See glossary at end of report for definition.*

For fiscal year 2005-06, Division records indicated collection of $367.6 million for amounts due on delinquent State taxes. The Division reported that $121.8 million (33%) of the total $367.6 million collected was attributable to the private collection agency's efforts. As of August 2007, the Division had 172 employees.

Audit Objective

The objective of our performance audit* of the Collection of Delinquent State Taxes, Department of Treasury, was to assess the effectiveness* of the Department of Treasury's efforts to pursue methods of collecting identified delinquent State taxes.

Audit Scope

Our audit scope was to examine the program and other records of the Department of Treasury related to the collection process for identified delinquent State taxes. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Supplemental information was obtained from the Department and is presented in Exhibits 1 through 4. Our audit was not directed toward expressing an opinion on this information and, accordingly, we express no opinion on it. We performed our initial audit procedures from May through August 2004. We performed additional audit procedures in July and August 2007 primarily to provide updated analyses of State Treasury Accounts Receivable (STAR) system data. Our audit procedures generally covered the period July 1, 2004 through August 31, 2007.

Audit Methodology

To establish our audit objective and to gain an understanding of the collection processes for identified delinquent State taxes, we conducted a preliminary review of the Department's Collection Division operations. This included discussions with Collection Division staff regarding their functions and responsibilities and examination of STAR system tax assessment records, applicable statutes, policies and procedures, reports, and other reference material.

To assess the effectiveness of the Department's efforts to pursue methods of collecting identified delinquent State taxes, we reviewed the collection enforcement actions and

** See glossary at end of report for definition.*

procedures used by the Department, analyzed and evaluated STAR system tax assessments, examined the use of third-party collection agency contractors, and researched collection enforcement actions used by other states and the federal Internal Revenue Service.

Our audit scope did not attempt to measure the effectiveness of the Department's efforts in terms of dollars or collection rate percentage for delinquent tax collection. Based on the absence of observable industry standards and the premise that the collection of any debt is largely dependent on the debtor's ability to pay, our audit efforts were confined to examining the completeness of the collection procedures used by the Department and researching private, federal, and other state collection practices to identify additional methods that the State should consider implementing.

We use a risk and opportunity based approach when selecting activities or programs to be audited. Accordingly, our audit efforts are focused on activities or programs having the greatest probability for needing improvement as identified through a preliminary review. By design, our limited audit resources are used to identify where and how improvements can be made. Consequently, our performance audit reports are prepared on an exception basis.

Agency Responses and Prior Audit Follow-up

Our audit report contains 2 findings and 3 corresponding recommendations. The Department's preliminary response indicates that it partially agrees with 1 recommendation and agrees with 2 recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require the Department of Treasury to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

We released our prior performance audit of the Collection Division, Department of Treasury (27-150-01), in June 2002. The Department complied with 3 of the 4 prior audit recommendations. The remaining recommendation was rewritten in this report.

COMMENT, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS OF EFFORTS TO PURSUE METHODS OF COLLECTING IDENTIFIED DELINQUENT STATE TAXES

COMMENT

Background: Act 122, P.A. 1941, as amended, enacted provisions that the Department of Treasury must adhere to in the establishment and collection of delinquent State taxes. The provisions are explained within the Taxpayer Rights Handbook, which is a public document prepared by the Department. Delinquent State taxes are identified and forwarded to the Department's Collection Division by the division responsible for administration of the respective tax within the Department. The respective divisions identify delinquencies based on actual examination of filed returns or from computations using available information in the event that a taxpayer fails to file his/her tax return.

The Collection Division maintains a record of each delinquency on an automated information system called the State Treasury Accounts Receivable (STAR) system. Once the delinquency is forwarded to STAR, the system initiates the formal delinquent tax assessment process by preparing a notice of intent to assess* and/or a notice of final assessment*. These notices provide the taxpayer with an opportunity to resolve the debt by paying the amount due, appealing the assessment, or entering into an installment payment plan with the Collection Division.

If the tax debt is not resolved, the Collection Division may proceed to collect the delinquent State tax through collection enforcement actions. Methods currently used by the Department include telephone and additional written correspondence; accrual of interest against the taxpayer on the unpaid debt; recording of tax liens on the real and personal property of delinquent taxpayers; garnishment of wages; financial institution account levies; issuance of tax warrants, which allows the Department to close businesses and/or seize and sell business-related assets; revocation or denial of renewal liquor and sales tax licenses registered to delinquent taxpayers; assessment of the tax, penalty, and interest owed by a business against its officers, partners, or other individuals responsible for filing and paying the business taxes; and offsetting of delinquent taxpayers' State income tax refunds, lottery winnings, and payments by the State for vendor services performed. In addition, the Department contracts with a

* *See glossary at end of report for definition.*

third-party collection agency to locate information on the taxpayers' whereabouts and existence of any assets on which the Department can place a lien or levy, to discuss the tax debt and possible collection enforcement actions with the taxpayers, and to ultimately pursue collection of the delinquent State tax by recommending enforcement action be taken by the Collection Division.

Based on the absence of observable industry standards and the premise that the collection of any debt is largely dependent on the debtor's ability to pay, our audit efforts were confined to examining the completeness of the collection procedures used by the Department and researching private, federal, and other state collection practices to identify additional methods that the State should consider implementing. Therefore, our audit scope did not attempt to measure the effectiveness of the Department's efforts in terms of dollars or collection rate percentage for delinquent tax collection.

Audit Objective: To assess the effectiveness of the Department's efforts to pursue methods of collecting identified delinquent State taxes.

Audit Conclusion: We concluded that the Department's efforts were effective in pursuing methods of collecting identified delinquent State taxes. However, our assessment disclosed two reportable conditions* related to tax liens and credit card payment options (Findings 1 and 2).

FINDING

1. Tax Liens

   The Department had not collected and analyzed data to determine and implement the most effective and efficient use of liens to help protect the security interest of the State and to help collect delinquent State taxes. As a result, the Department could not justify the liens it did and did not record on the property of delinquent taxpayers.

   The Department places liens on the property of delinquent taxpayers to protect the State's security interest in the tax debt and to establish priority against other creditors. Although not a guarantee of payment, recording tax liens may increase the likelihood of collection by providing security (i.e., collateral) for the payment of delinquent State taxes. Failure to record a tax lien may negate the State's priority

* *See glossary at end of report for definition.*

right against other creditors when the taxpayer has property and may negatively affect the collection of State tax revenue. Placing liens on taxpayer property involves both direct and indirect costs; therefore, the Department could increase the efficiency of its lien process by placing liens only on those tax accounts for which the lien is necessary to protect the security interest of the State and is more likely to have a positive effect on the collection of the tax due to the State.

Section 205.29 of the *Michigan Compiled Laws* authorizes the Department to record tax liens on the property of delinquent taxpayers. The Department records tax liens through the Secretary of State (personal property) or applicable county register of deeds (real property) to secure the State's interest in the property of the debtor until the debt is satisfied or the lien expires as provided by statute. A tax lien begins on the date that the applicable tax return was due and continues for seven years or until the applicable debt is paid. The Department may extend tax liens for an additional seven years by refiling the lien at least six months prior to the expiration date of the original seven-year period.

The Department's due process for delinquent taxes begins with a letter notifying the taxpayer of the tax liability and proceeds through actions including garnishments, levies, and liens. The Department's collection procedures allow for professional judgment, in conjunction with established policies, in determining the specific action to be used to collect the tax due. We identified 40,726 delinquent taxpayer accounts as of July 2004 with a total outstanding balance of $365.5 million that met the Department's established criteria for recording a lien but for which the Department had not recorded liens on the property of the delinquent taxpayers. However, the Department had not collected data to provide its staff with more detailed guidance on which of these accounts the State's security interest or the collection of the delinquent tax would benefit from the placement of a lien.

The Department analyzed delinquent tax accounts that were closed in calendar year 2004 because they were beyond the statute of limitations for collection or had been paid in full. However, the analysis did not provide data that allowed the Department to quantify the effectiveness of tax liens in achieving protection of the State's security interest or the collection of delinquent State taxes because it did not determine whether the tax payments it received resulted from the placement of the liens. Also, for those accounts on which the Department did not record a lien and did not receive payment, the analysis did not evaluate the likelihood that the Department would have collected delinquent State taxes if it had recorded a lien.

The Department should consider analyzing those accounts on which it placed liens and received payment to identify common characteristics in accounts that make the use of liens an effective tool in protecting the State's security interest and in collecting delinquent taxes. Such attributes might include determining on which tax debts the State is more likely to need to protect its security interest from other creditors, whether liens on certain property owned by taxpayers have more of an effect on collecting the delinquent tax, and whether the timing of the placement of liens impacts the likelihood of payment. An analysis may allow the Department to modify its general lien placement guidelines to help increase the effectiveness and efficiency of liens and identify the most effective time to place the liens during the Department's due process.

RECOMMENDATION

We recommend that the Department collect and analyze data to determine and implement the most effective and efficient use of liens to help protect the security interest of the State and to help collect delinquent State taxes.

AGENCY PRELIMINARY RESPONSE

The Department partially agrees with the finding and recommendation. The Department informed us that it believes that it already collects and analyzes a substantial amount of data to appropriately manage the placement of liens. However, the Department agrees to research and discuss this recommendation with a statistician to determine if there is a viable way to implement the recommendation.

The Department stated that, as a matter of policy and consistent with statute, it uses the filing of a tax lien to protect the State interest by securing the State's ability to collect a tax debt. The filing of a tax lien is not done in isolation of other efforts to collect delinquent tax debt.

The Department informed us that its Collection Division has increased the level of dedicated resources necessary to review, approve, and process tax liens over the years. The Department also informed us that it has increased the number of liens dramatically since the fiscal year 2003-04 Office of the Auditor General (OAG) review period and, as of April 2008, 67% of all accounts eligible for placement of a lien have had a lien placed against the taxpayer.

The Department considers the OAG finding to place significant emphasis on the use of liens as a tool to increase collections, versus the Department's view that it is primarily a tool to secure the State's interest. Further, the Department stated that to implement the OAG recommendation would require access to individual and business financial information, not currently in the hands of the Department, and may require access to other State and local systems. In addition, the Department informed us that the benefits derived may not justify additional costs for enhancements to the Department systems. The Department stated that it will consider the cost-effectiveness of this approach.

The Department informed us that it continues to balance the collection of debt with the impact on the taxpayer and the related cost of collection. The Collection Division will continue it efforts to improve the use of the tax lien.

FINDING

2. Credit Card Payment Options

The Department should perform a cost-benefit analysis of allowing taxpayers the ability to use credit cards to pay State taxes. In addition, if the Department's analysis supports the use of credit cards as a method of paying State taxes, the Department should seek amendatory legislation to authorize the use of credit cards as a payment option.

Some benefits of allowing taxpayers the option of paying their taxes using a credit card include potentially increasing the collection of delinquent taxes, reducing processing costs associated with check payments, reducing the overall number of delinquent tax assessments generated by the Department, and providing increased convenience for citizens.

Current State statutes do not permit the Department to accept credit cards as a payment method for current or delinquent State taxes. Section 205.19 of the *Michigan Compiled Laws* provides that all payments of taxes shall be made to the Department by cash, check, money order, or electronic funds transfer from the taxpayer's bank account.

The Department informed us that it has discussed the possibility of accepting credit cards as a payment method for taxes, but it has not performed an analysis of the cost benefit of allowing taxpayers the option of paying their taxes with a credit card.

Our research of collection practices used by other states identified 25 states that currently allow taxpayers to pay their tax liability using a credit card. These states entered into nonmonetary contracts with a third-party service provider that facilitates the credit card payments on behalf of the states. As compensation for facilitating the transaction, the third-party service provider independently charges the taxpayer a convenience fee. The federal Internal Revenue Service has also entered into a nonmonetary contract to facilitate credit card payments for certain federal tax debts. In addition, the Michigan Secretary of State accepts credit card payments for various vehicle and licensing transactions.

RECOMMENDATIONS

We recommend that the Department perform a cost-benefit analysis of allowing taxpayers the ability to use credit cards to pay State taxes.

We also recommend that, if the Department's analysis supports the use of credit cards as a method of paying State taxes, the Department seek amendatory legislation to authorize the use of credit cards as a payment option.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendations. It will conduct a cost-benefit analysis of the use of credit cards to pay delinquent tax debt. If the Department's cost-benefit analysis supports the use of credit cards to pay State taxes, the Department will resurrect the question of the use of credit cards to pay delinquent tax debt.

The Department informed us that it has reviewed the use of credit cards to pay delinquent State debt, including taxes, over the years. The Department stated that, not withstanding the fact that other states and the federal government allow credit card payment of taxes, there are public policy implications of shifting tax debt to the credit card arena. The Department further stated that this shift adds to the overall credit card debt within the country and increases the pressure of credit card delinquency rates.

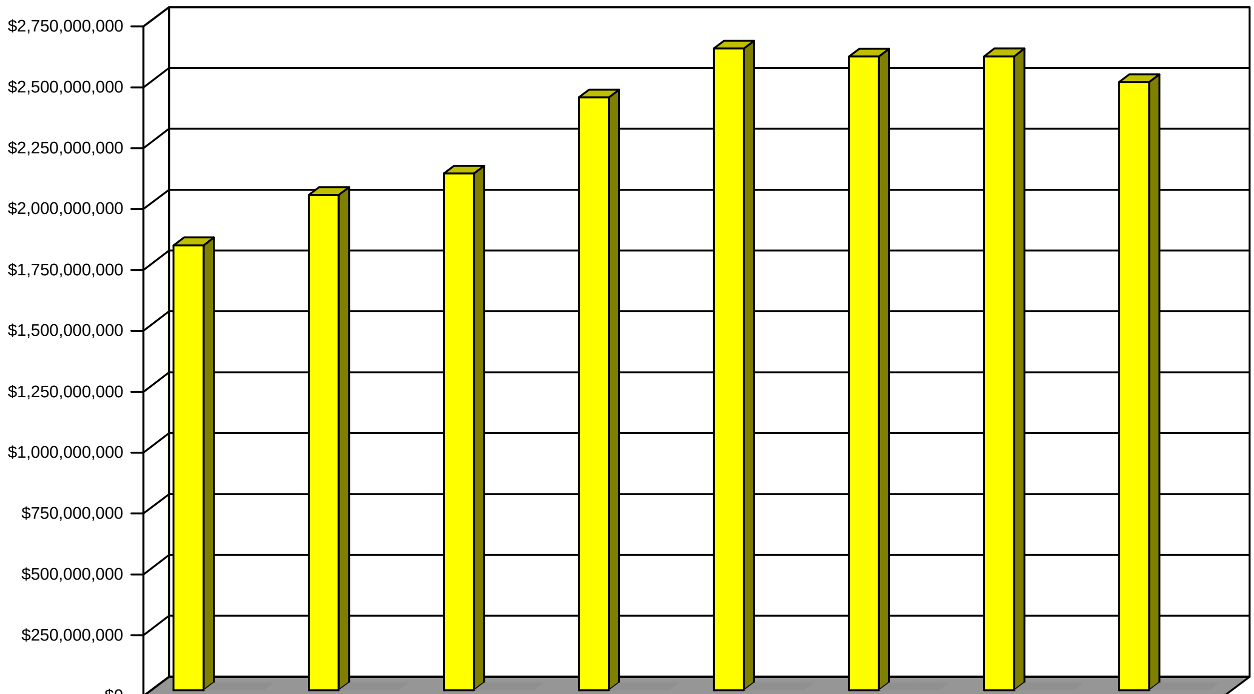
Taxes have priority in bankruptcy proceedings and are not discharged. Until recently, taxes paid by credit card did not have a priority within the bankruptcy statutes. This allowed credit card tax payments to be discharged, adding to general credit card loss. In 2005, bankruptcy statutes were amended to allow another creditor who paid the tax debt to retain that debt as nondischarged in bankruptcy proceedings. The Department stated that there is little annotation in statute to establish how the courts are applying this statute or the consequences of this change. The Department informed us that the concern of increasing credit card default rates remains. The Department stated that these financial losses are absorbed by all citizens in the form of increased interest rates and can adversely affect credit markets.

SUPPLEMENTAL INFORMATION

UNAUDITED
Exhibit 1

COLLECTION OF DELINQUENT STATE TAXES
Department of Treasury

Assessed Taxes Receivable Outstanding Balance by Fiscal Year
For Fiscal Years 1998-99 Through 2005-06



	1999	2000	2001	2002	2003	2004	2005	2006
Gross Assessed Taxes Receivable (ATR)	$1,827,335,997	$2,033,827,506	$2,122,554,735	$2,434,299,068	$2,635,772,232	$2,602,887,514	$2,603,500,346	$2,497,334,334
Number of Outstanding Tax Accounts	370,761	406,257	365,980	548,215	462,845	515,181	457,793	440,828
Average ATR per Outstanding Tax Account	$4,929	$5,006	$5,800	$4,440	$5,695	$5,052	$5,687	$5,665

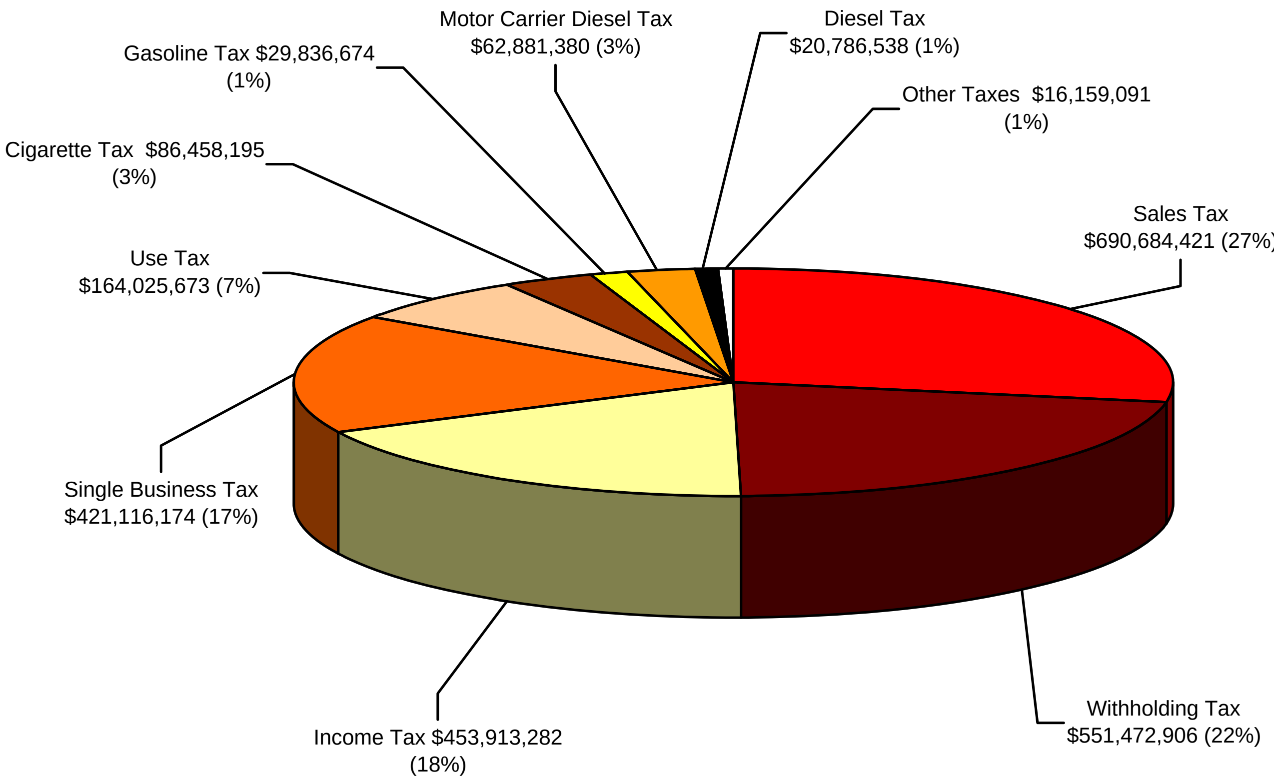
Fiscal Year Ended September 30

Source: Department of Treasury.

UNAUDITED
Exhibit 2

COLLECTION OF DELINQUENT STATE TAXES
Department of Treasury

Assessed Taxes Receivable Outstanding Balance by Tax Type
As of September 30, 2006

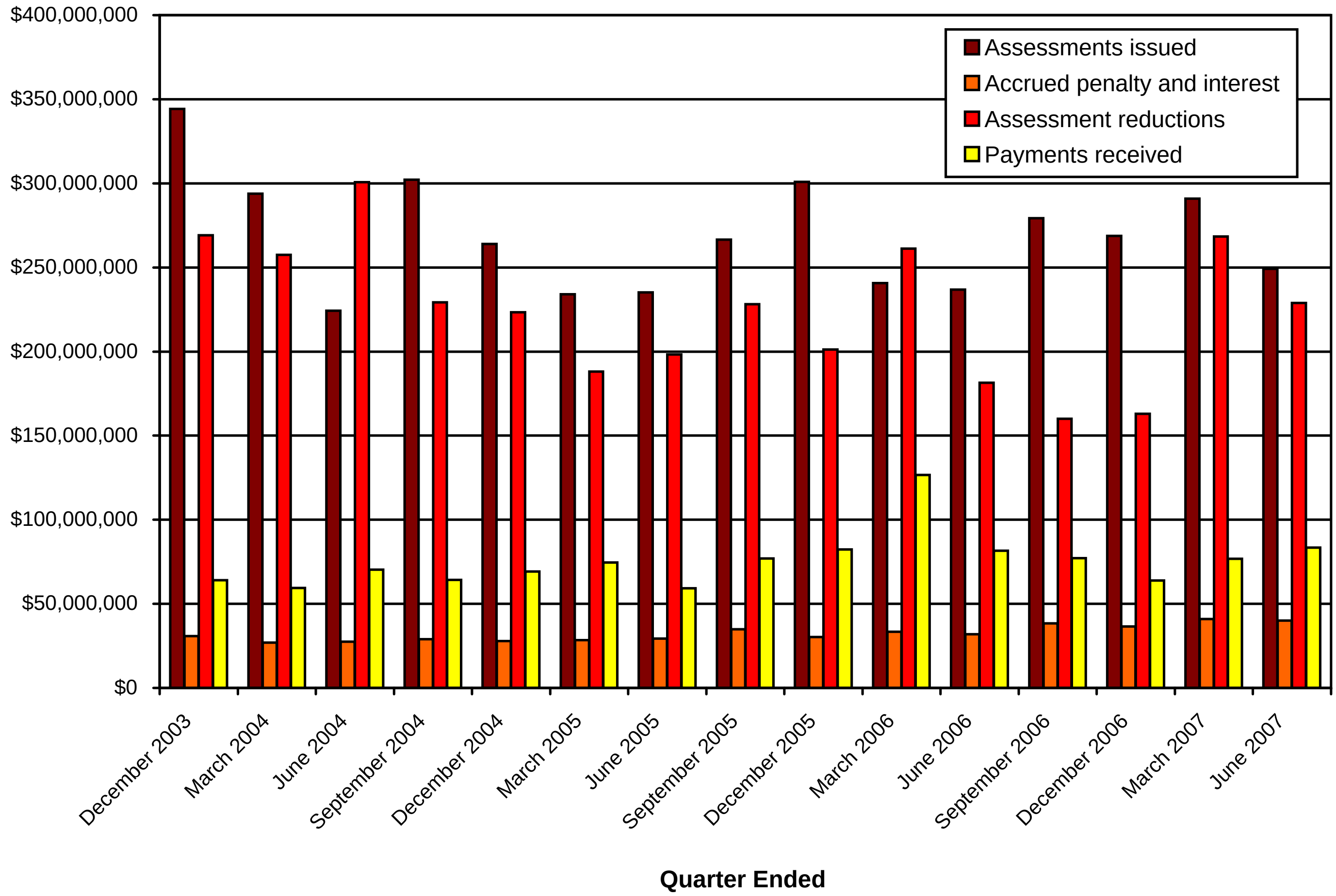


Source: Department of Treasury.

271-0153-07

COLLECTION OF DELINQUENT STATE TAXES
Department of Treasury

Tax Assessments Issued, Accrued Penalty and Interest, Assessment Reductions, and Payments Received by Fiscal Year Quarter
For the Quarters Ended December 2003 Through June 2007

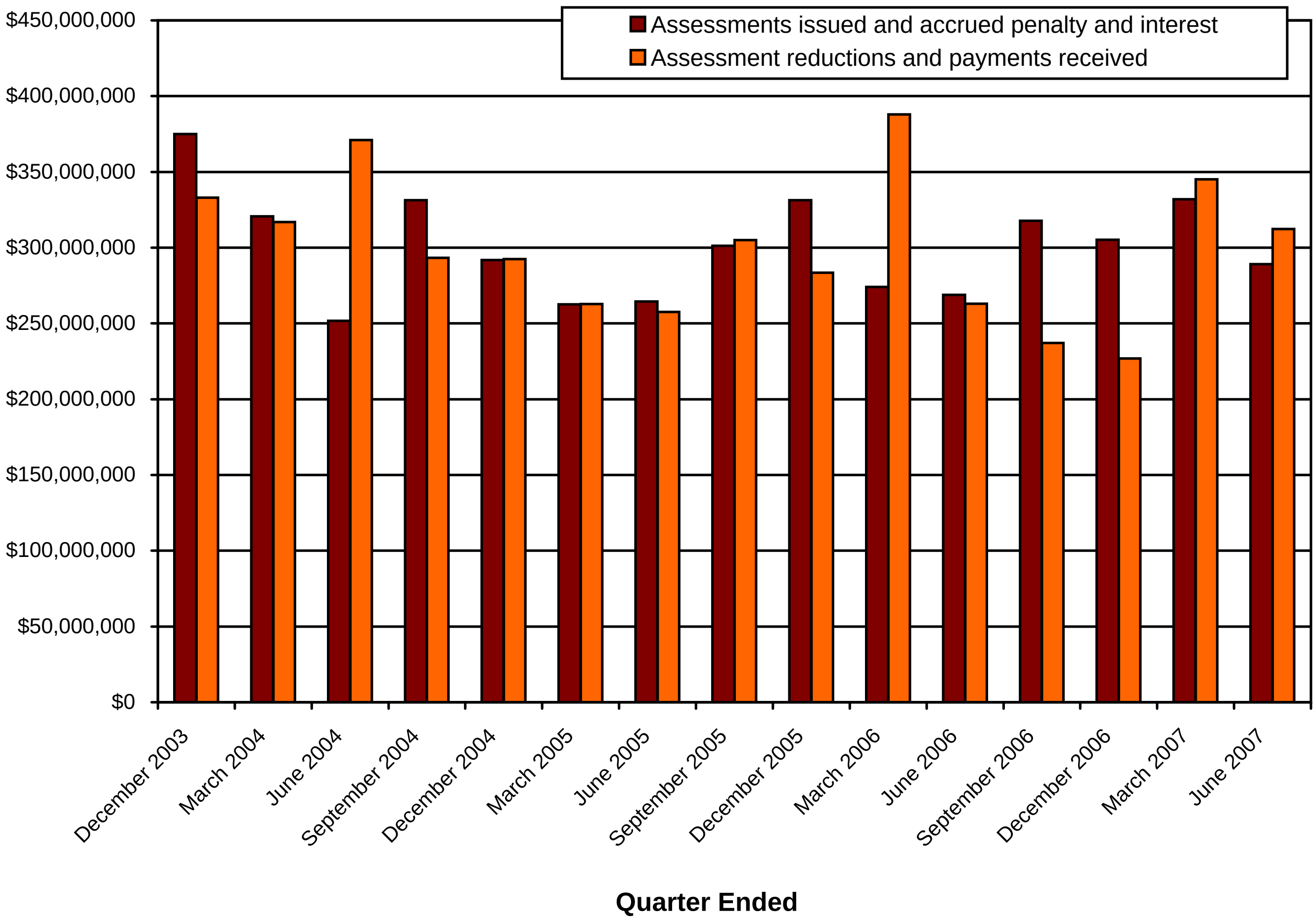


Source: Department of Treasury.

UNAUDITED
Exhibit 4

COLLECTION OF DELINQUENT STATE TAXES
Department of Treasury

Comparison of Tax Assessments Issued and Accrued Penalty and Interest to Assessment Reductions and Payments Received by Fiscal Year Quarter
For the Quarters Ended December 2003 Through June 2007



Source: Department of Treasury.

GLOSSARY

assessment	An amount determined as payable by the Department of Treasury when a taxpayer fails or refuses to file a return or make a payment, in whole or in part, or when the Department believes that a taxpayer has not provided sufficient information to determine the amount of tax due.
ATR	assessed taxes receivable.
effectiveness	Program success in achieving mission and goals.
notice of final assessment	The notice which advises the taxpayer that an assessment issued by the Department of Treasury is final and subject to appeal.
notice of intent to assess	The notice which advises the taxpayer of the Department of Treasury's intent to assess the tax and provides the amount of the tax that the Department believes the taxpayer owes, the reason for the deficiency, and a statement that advises the taxpayer of his/her right to an informal conference and the requirements for an informal conference.
OAG	Office of the Auditor General.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.
reportable condition	A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in

management's ability to operate a program in an effective and efficient manner.

STAR State Treasury Accounts Receivable.

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