

OFFICE OF THE STATE INSPECTOR GENERAL  
Performance Review Report to  
Craig M. Burns, Commissioner  
Virginia Department of Taxation

July 2017



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*COMMONWEALTH OF VIRGINIA*  
*Office of the State Inspector General*

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July 25, 2017

Craig M. Burns, Commissioner  
Department of Taxation  
P.O. Box 2475  
Richmond, VA 23218

Dear Commissioner Burns:

In accordance with *Code of Virginia (Code)* [§ 2.2-309](#) [A](10), the Office of the State Inspector General (OSIG) is empowered to conduct performance reviews of state agencies to ensure that state funds are spent as intended and to evaluate the efficiency and effectiveness of programs in accomplishing their purposes. Based on this authority, OSIG conducted a performance review of the Department of Taxation. The review covered the period of July 1, 2015 to June 30, 2016.

Initially, the review focused on the following risk areas:

- General Fund Appropriations;
- Non-General Fund Revenue;
- Agency Operations; and
- Employee Training/Competency.

TAX was selected for review in these areas based on a 2013 statewide risk assessment completed by Deloitte, LLP. The risk assessment ranked TAX as the second highest risk agency of all executive branch agencies.

The planning phase of the review consisted of conducting interviews with selected members of TAX's executive and divisional management and assessing the risks identified during those interviews. OSIG narrowed the risk areas for further review to Agency Operations, specifically:

- Income Tax Processing; and
- Tobacco Enforcement.

OSIG identified specific objectives for the risk area and developed a detailed review plan to accomplish the objectives. The steps in the review plan were executed and the results were discussed with TAX management in a teleconference on June 21, 2017.

Observations identified during the review and TAX management's responses to OSIG's recommendations are included in the attached report.

OSIG appreciates the assistance provided by TAX staff and the various local commissioners' of the revenue and treasurers' staffs during this review.

If you have any questions or require further information, please contact me at (804) 625-3255 or [michael.westfall@osig.virginia.gov](mailto:michael.westfall@osig.virginia.gov).

Respectfully,



Michael C. Westfall, CPA  
Acting State Inspector General

CC: Paul J. Reagan, Chief of Staff to Governor McAuliffe  
Suzette P. Denslow, Deputy Chief of Staff to Governor McAuliffe  
Richard D. Brown, Secretary of Finance  
The Honorable Thomas K. Norment Jr., Co-Chairman, Senate Finance Committee  
The Honorable Emmett W. Hanger, Jr., Co-Chairman, Senate Finance Committee  
The Honorable R. Lee Ware, Chairman, House Finance Committee

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## Executive Summary

The Office of the State Inspector General (OSIG) reviewed the risk area of Agency Operations at the Department of Taxation (TAX), with a specific focus on Income Tax Processing and Tobacco Enforcement.

The review had the following objectives:

- Determine whether locality involvement in state income tax processing is necessary in providing quality customer service to the citizens while also being cost effective for the Commonwealth.
- Determine whether there are any indicators or opportunities for fraud, waste or abuse in the income tax process that occurs between the localities and TAX in processing income tax returns.
- Determine whether TAX involvement with enforcing state laws regarding the sale of cigarettes allows for the most effective management and monitoring of tobacco sales for the Commonwealth.

As part of this review, OSIG performed the following procedures:

- Gained an understanding of the risk area by reviewing policies and procedures;
- Conducted interviews with TAX management and division staff, the Office of the Attorney General (OAG) staff, as well as staff from a sample of commissioners' of the revenue and treasurers' offices;
- Gathered and analyzed data obtained from TAX staff;
- Gathered and analyzed data obtained from State Compensation Board (SCB) staff;
- Researched applicable laws and regulations;
- Conducted observations and walkthroughs of the various processes; and
- Researched other states' practices for similar processes and organizational structure.

All of the objectives were met. At the conclusion of the review, OSIG provided the following recommendations for TAX:

<b>RECOMMENDATIONS</b>
1. TAX should work with the OAG to identify areas in the stamping agent review and retail inspection processes where resources could be leveraged to avoid duplication of effort while maintaining effective oversight.
2. TAX should develop a method to capture and compile a comprehensive list of tobacco retailers that could be available for use by all agencies with tobacco enforcement responsibilities.
3. Tobacco Unit management should determine which performance measures would be most appropriate for the goals and objectives of the office. Once measures have been identified, management should periodically prepare a documented comparison of actual measures to standards or targets to assess performance. Such reviews can identify areas requiring management attention for improvement, or may indicate unrealistic standards or goals that need revision. Several performance measures were discussed with TAX management for consideration.

## Purpose and Scope of the Review

The Office of the State Inspector General (OSIG) conducted a performance review of the Department of Taxation (TAX) pursuant to *Code of Virginia* (Code) [§ 2.2-309](#). [A] (10) whereby the State Inspector General shall have power and duty to:

*“Conduct performance reviews of state agencies to assess the efficiency, effectiveness, or economy of programs and to ascertain, among other things, that sums appropriated have been or are being expended for the purposes for which the appropriation was made and prepare a report for each performance review detailing any findings or recommendations for improving the efficiency, effectiveness, or economy of state agencies, including recommending changes in the law to the Governor and the General Assembly that are necessary to address such findings.”*

This review was not designed to be a comprehensive review of TAX. Instead, the focus was on certain risk areas identified through a statewide risk assessment of state agencies completed by Deloitte, LLP. The scope and objectives of the review were established through interviews with management concerning TAX’s risk in the area of Agency Operations, specifically:

- Income Tax Processing; and
- Tobacco Enforcement.

The review period was from July 1, 2015 through June 30, 2016.

The review objectives were to:

- Determine whether locality involvement in state income tax processing is necessary in providing quality customer service to the citizens while also being cost effective for the Commonwealth.
- Determine whether there are any indicators or opportunities for fraud, waste or abuse in the income tax process that occurs between the localities and TAX in processing income tax returns.
- Determine whether TAX involvement with enforcing state laws regarding the sale of cigarettes allows for the most effective management and monitoring of tobacco sales for the Commonwealth.

## Background

The mission of TAX is to serve the public by administering the tax laws of the Commonwealth of Virginia with integrity, efficiency and consistency.<sup>1</sup> Under the purview of the Secretary of Finance and created in 1927, the department is responsible for thirty-nine different taxes.<sup>2</sup> Commonly known taxes include income and sales; however, TAX also administers lesser known taxes involving commodities, tobacco products and insurance premiums. TAX's other responsibilities include forecasting Commonwealth revenues and providing assistance to localities with their real estate valuation and assessments.

Organizationally, TAX is headed by the Tax Commissioner and is divided into four key functional units:

- Office of Administration – Performs TAX's support for fiscal, purchasing, warehousing, public relations, mail operations and business process improvement.
- Office of Technology – Responsible for risk management and security operations, database management and application support, external web applications, report interfaces and infrastructure.
- Office of Tax Policy – Handles legislative issues and/or development of policy related to the tax code, administrative tax appeals, offers in compromise and administrative clarifications.
- Tax Operations – Comprised of three areas including: (a) General Legal and Technical Services, which handles miscellaneous taxes such as commodities, TAX's tobacco compliance program, Freedom of Information Act (FOIA) requests and land preservation credits; (b) Tax Processing, which handles tax return document and automated processes such as return and payment processing, data capture, scanning and eServices; and (c) Compliance and Customer Services, which is responsible for tax audits and collections, error resolution and customer assistance.

### Income Tax Processing

The Tax Processing Operations section of TAX processes state tax returns and payments for both paper and electronic submissions. Paper return and payment processing includes several manual activities to prepare and process the items in the agency's revenue management system. Electronic return and payment processing includes the administration of several online file and pay systems. This area is also responsible for the manual processing of inbound correspondence,

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<sup>1</sup> Department of Taxation website 'Who We Are': <https://tax.virginia.gov/who-we-are>

<sup>2</sup> Tax Facts 2015 Final

issuing tax refunds, registering businesses and processing returned mail (bills, letters and refund checks).<sup>3</sup>

By law, all state income tax returns are required to be filed with the local Commissioner of the Revenue (Code of Virginia [§ 58.1–343](#)), but each local office determines whether they will accept and process returns and payments. Most returns and return payments are sent to TAX either via mail or electronically and are considered direct-filed returns. Local-filed returns are those in which the local office accepts the returns and performs some initial processing on them to include screening the returns for accuracy and completeness and batching and sending the returns to TAX for processing. Local processing steps vary based on the type of return: refund or tax due.

## Tobacco Enforcement

In November 1998, the four largest cigarette manufacturers (known as the Original Participating Manufacturers – OPM), along with the Attorneys General of 46 states, the Commonwealth of Puerto Rico and the District of Columbia entered into what is called the Master Settlement Agreement (MSA), the largest civil litigation settlement in U.S. history, to settle states’ suits to recover billions of dollars in costs associated with treating smoking-related illnesses. As outlined in the MSA, each of the settling states gave up any future legal claims they might have based on the cigarette companies’ actions at issue in the settled lawsuits. In exchange, the companies signing the MSA (Participating Manufacturers – PM) agreed to make annual payments in perpetuity to the settling states to compensate them for taxpayer money spent for health-care costs connected to tobacco-related illness. The MSA also sets standards and imposes restrictions on the sale and marketing of cigarettes by participating cigarette manufacturers; imposes prohibitions and restrictions on cigarette marketing and advertising practices; and includes other requirements and restrictions regarding tobacco company conduct.

The sale of cigarettes within Virginia is regulated by federal and state law and enforced by TAX.<sup>4</sup> TAX does not license cigarette manufacturers to produce or sell cigarette products in the Commonwealth. However, cigarette manufacturers selling cigarettes to consumers within Virginia, whether directly or through a distributor or similar intermediary, must become listed on the Virginia Tobacco Directory published on the Office of the Attorney General’s website<sup>5</sup> in accordance with Code of Virginia §§ [3.2-4205](#) and [3.2-4206](#). Cigarette manufacturers must also

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<sup>3</sup> Department of Taxation Strategic Plan: [https://solutions.virginia.gov/pbreports/rdPage.aspx?rdReport=vp\\_StratPlan102&selAgency=161&selVersion=2014-16&run=Run](https://solutions.virginia.gov/pbreports/rdPage.aspx?rdReport=vp_StratPlan102&selAgency=161&selVersion=2014-16&run=Run)

<sup>4</sup> Department of Taxation website: <https://www.tax.virginia.gov/cigarette-and-tobacco-taxes>

<sup>5</sup> <http://www.oag.state.va.us/programs-initiatives/tobacco-enforcement>

a) become a participating manufacturer (PM) and perform their financial obligations under the MSA; or b) be a non-participating manufacturer (NPM) and place into a qualified escrow fund by April 15 of each year such amounts as directed under the Code of Virginia § [3.2-401](#).

Virginia currently imposes a cigarette excise tax in the amount of 1.5 cents per cigarette. This equates to 30 cents per pack for a standard pack of 20 cigarettes, or \$3.00 per carton. Payment of the tax is evidenced by affixing a Virginia Revenue Stamp (cigarette stamp) to each pack of cigarettes. Only suppliers who have applied for and received a Stamping Agent Permit from TAX may purchase Virginia cigarette stamps. TAX is the only authorized dealer of cigarette stamps and the stamps may neither be resold by, returned to, transferred to, or purchased from, parties other than TAX. Every stamping agent who sells, stores or receives cigarettes for the purpose of distribution to any person, firm, corporation or association within Virginia must pay the state excise tax on such cigarettes by affixing stamps to the cigarette packs. There are only a few exceptions to this requirement. Persons in possession of unstamped cigarettes are liable for the payment of the excise tax as well as a penalty of \$2.50 per pack, up to \$250,000.

Overall, TAX is primarily responsible for ensuring proper payment of cigarette tax, Other Tobacco Products (OTP) tax and sales tax due on cigarette sales. In addition, the Office of the Attorney General has primary responsibility for assuring compliance with the MSA, although the Department of Alcoholic Beverage Control (ABC) conducts underage buyer checks and advertising and labeling inspections in accordance with agreement guidelines.

## Review Methodology

OSIG conducted this review by:

- Examining the detailed results of Deloitte’s statewide risk assessment; and
- Conducting interviews to gain insight into specific concerns in risk areas with:
  - Deputy Tax Commissioner, Tax Operations;
  - Assistant Commissioner, Office of General Legal and Technical Services;
  - Assistant Commissioner, Office of Tax Processing;
  - Assistant Commissioner, Office of Compliance;
  - Assistant Commissioner, Office of Customer Services;
  - Assistant Commissioner, Office of Tax Policy;
  - Chief Administrative Officer, Office of Administration;
  - Chief Technology Officer, Office of Technology;
  - Director, Revenue Forecasting;
  - Human Resources Manager, Human Resources;
  - Training and Instruction Manager, Human Resources;
  - Unit Manager, Land Preservation Credits;
  - Director, Internal Audit; and
  - Auditor of Public Accounts (APA) staff (for Department of Taxation).

As a result of the aforementioned procedures, OSIG narrowed the scope of the review to the risk area of Agency Operations, specifically:

- Income Tax Processing; and
- Tobacco Enforcement.

OSIG then identified performance review objectives and developed detailed review procedures to address these objectives. Indicators or opportunities for fraud, waste, and abuse were also evaluated.

The performance review procedures included:

- Gaining an understanding of the risk areas;
- Interviewing a sample of local city and county commissioners of the revenue and treasurers;
- Researching applicable laws and regulations;
- Collecting and analyzing relevant data obtained from TAX staff and other sources;
- Conducting observations and walkthroughs; and
- Researching other states’ practices for similar processes and organizational structure.

During the review, OSIG made observations regarding effectiveness and efficiency of various processes within the risk area and made recommendations to address each observation. TAX management was provided an opportunity to respond.

## Review Results

Overall, OSIG found opportunities to improve efficiency and effectiveness. Specifics regarding the review performed are reported by risk area below.

### Risk Area - Agency Operations

#### Income Tax Processing

The local Commissioner of the Revenue office partners with TAX to receive and process income tax returns from Virginia taxpayers. This teamwork effort seeks to provide quality service to all taxpayers in processing individual tax returns and providing customer service information.

The review objectives included determining whether locality involvement in state income tax processing is necessary in providing quality customer service to the citizens while also being cost effective for the Commonwealth; and whether there were any indicators or opportunities for fraud, waste or abuse in the income tax process that occurs between the localities and TAX in processing income tax returns.

OSIG staff performed the following:

- Gained an understanding of the individual income tax return processing function;
- Determined the roles and responsibilities of the local Commissioner of the Revenue and Treasurer in income tax return processing;
- Analyzed statistics for the number of electronic, paper, direct-filed, local-filed and accelerated refund returns processed;
- Evaluated Virginia Compensation Board funding provided to the local commissioners of the revenue and treasurers to provide required state tax responsibilities;
- Researched structure of income tax return processing in a sample of other states; and
- Identified and documented possible symptoms or indicators of fraud, waste or abuse in processing income tax returns.

Individual income tax returns can be filed directly with TAX or with localities that have elected to accept them. When an individual income tax return is accepted at the locality it can be in the form of a tax-due return with or without payment included, a refund return eligible for accelerated refund processing, a refund return not eligible for accelerated refund processing, a refund return not eligible for locality processing (a prior year return), or a payment return. In all cases, the returns are sent to TAX for final processing. TAX must process the returns sent to them from the locality, but can also receive the aforementioned returns directly to the department for processing via mail or electronic filing.

Although there was no compelling evidence discovered to alter the existing process for individual income tax return filing and processing, the following was identified:

- More returns are being filed electronically than manually and more paper returns are being direct filed versus locally filed.

- The paper and electronically filed return data in the chart below is captured through the Advantage Revenue system utilized by TAX. As the return is posted to Advantage Revenue, it contains a Federal Information Processing Standard (FIPS) code which uniquely identifies the county or city of origin. This information can be used by TAX to determine the number of returns filed per locality.

<b>Calendar Year</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
<b>All Returns:</b>					
Direct Filed	3,504,655	3,533,376	3,638,821	3,701,230	3,853,116
Local Filed	331,912	267,625	253,813	234,354	205,770
* Accelerated Refunds	101,800	112,456	99,243	92,202	81,168
<b>**Total All Returns:</b>	<b>3,836,567</b>	<b>3,801,001</b>	<b>3,892,634</b>	<b>3,935,584</b>	<b>4,058,886</b>
<b>Paper Returns:</b>					
Direct Filed	871,854	807,225	727,475	749,435	715,339
Local Filed	331,912	267,625	253,813	234,354	205,770
<b>***Total Paper Returns</b>	<b>1,203,766</b>	<b>1,074,850</b>	<b>981,288</b>	<b>983,789</b>	<b>921,109</b>

\* Accelerated Refunds = Subset of local- filed returns that were processed for quick turnaround of refunds to customers.

\*\* Total All Returns = The total number of all returns processed – paper and electronic; local, and direct filed.

\*\*\* Total Paper Returns= The total number of paper returns only.

- The accelerated refund process was discontinued effective December 1, 2016, thus eliminating a significant incentive for individual income tax return filing in the locality.

Accelerated refund processing provided for a quick turnaround of refunds to customers who filed eligible returns with local Commissioner of the Revenue offices. This shortening of the initial processing cycle got the refund into the customer’s hands in a shorter period of time. However, as refund fraud and identity theft have risen nationwide, revenue agencies are subjecting refund returns to greater scrutiny and review. Unfortunately, accelerated refunds presented additional challenges. These refunds were issued after review of very limited tax return data and the returns did not pass through TAX fraud evaluation models. The paper return was processed well after the refund had been issued. Once the refund is issued, it’s very difficult to recover the funds if it is discovered that the return was fraudulent. With the process discontinued, locality staff will screen the returns and forward them to TAX for normal tax-return processing. Refunds for paper-filed returns could take up to eight weeks for the taxpayer to receive.<sup>6</sup>

- SCB funding is not sufficient to support state statutorily mandated duties for constitutional offices.

<sup>6</sup> Department of Taxation website: <https://tax.virginia.gov/wheres-my-refund>

Because nearly 95% of the SCB's annual appropriation for constitutional officers is for staff salaries, the SCB uses workload-based staffing standards to determine the total number of positions that each officer is due to perform duties mandated by state law. These standards were developed by the constitutional officers associations, and adopted by the Compensation Board.<sup>7</sup>

According to the SCB executive secretary, funding for commissioners of the revenue and treasurers could be tied to state income-related tasks, but not because inadequate funding is appropriated in support of these offices. The SCB is responsible for providing a fair allocation of the limited funding provided for constitutional offices, which is appropriated by the General Assembly to support their statutorily mandated duties. For objectivity in the allocation of funding, the Compensation Board uses standards based on workload measures that weight transactions processed in these offices. The SCB executive secretary stated that ideally constitutional officers would be fully funded by the Commonwealth for workload-related staffing that falls under their purview as designated in the Code of Virginia, but they are not.

While staffing standards include workload related to state income tax processing, these duties are not fully funded. Based upon budget reductions experienced especially by commissioners of the revenue and treasurers, data received from the SCB reported that commissioners' staffing needs as of FY17 are only 60% funded and treasurers' staffing needs are only 52% funded. The SCB executive secretary conveyed that at this point in time, funding from the Compensation Board to support commissioners and treasurers would not be affected if tasks related to state income tax processing were not done locally. There would be indirect savings by reducing the degree to which these offices are underfunded for their staffing needs but there would be no direct cost savings. For example, current staffing standards provide that an additional 369 positions are warranted statewide in Commissioner's offices based on workload. Eliminating all state income tax workload would still result in an additional 324 positions warranted statewide. This would result in an indirect reduction of 45 positions statewide that are presently not provided or funded by the Commonwealth. For treasurers, current staffing standards provide that an additional 481 positions are warranted statewide based upon workload. Eliminating all state income tax workload would still result in an additional 469 positions warranted statewide. This would result in an indirect reduction of 12 positions due statewide that are presently not provided or funded by the Commonwealth.

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<sup>7</sup> Compensation Board website: <http://www.scb.virginia.gov/faqsmenu.cfm>

- Citizen services
  - Although more individual income tax returns are being electronically filed, it was noted during interviews with a sample of local commissioners of the revenue that there remains a population of citizens that need assistance because they do not have access to or technical knowledge of computers to complete electronic filing, and/or do not feel they have the necessary tax knowledge to complete the return.
  - Once citizens file the individual income tax return through the locality, there is limited information available from the locality regarding the status of the return. There is no interfacing system between TAX and the locality. Subsequent to sending the individual income tax return for processing, the locality captures (on a manual spreadsheet or their local computer system) such details as customer name and address and when the return was sent to TAX.
- Laws governing the current process are involved.  
*Code of Virginia* Title 58.1 Taxation, Chapter 3, addresses the responsibilities of commissioners of the revenue and treasurers in the handling of income tax returns and payments in the following sections:

<b><i>Code of Virginia Section</i></b>	<b><i>Description</i></b>
<b>Commissioners of Revenue:</b>	
<a href="#"><u>§ 58.1-305</u></a>	Duties of commissioner of the revenue relating to income tax
<a href="#"><u>§ 58.1-307</u></a>	Disposition of returns; handling of state income tax payments
<a href="#"><u>§ 58.1-350</u></a>	Collection of delinquent tax
<a href="#"><u>§ 58.1-352</u></a>	Memorandum assessments
<a href="#"><u>§ 58.1-3535</u></a>	Commissioner of the revenue to furnish information to the treasurer
<a href="#"><u>§ 58.1-495</u></a>	Payment of estimated tax; notice of installment due; information to be transmitted to Virginia Tax
<b>Treasurers:</b>	
<a href="#"><u>§ 58.1-307</u></a>	Disposition of returns; handling of state income tax payments
<a href="#"><u>§ 58.1-351</u></a>	When, where and how individual income taxes payable and collectible
<a href="#"><u>§ 58.1 - 353</u></a>	Duties of county and city treasurer in collecting tax
<a href="#"><u>§ 58.1-495</u></a>	Payment of estimated tax; notice of installment due; information to be transmitted to Virginia Tax

Many of the aforementioned *Code of Virginia* sections require commissioners of the revenue and treasurers to perform certain duties in concert with TAX. A change in the existing process that would exclude locality involvement in individual income tax return processing could require legislative amendment(s). As previously mentioned, there was no compelling evidence to suggest alterations to the existing process for individual income tax return filing and processing. However, if TAX does make a change, the cumulative impact of the individual items detailed in this section are issues to be considered.

## Tobacco Enforcement

The review objective was to determine whether TAX involvement with enforcing state laws regarding the sale of cigarettes allows for the most effective management and monitoring of tobacco sales for the Commonwealth. TAX is not a law enforcement agency. However, it does have responsibility to assure compliance with laws that govern the taxation of cigarettes in the Commonwealth.

OSIG staff performed the following:

- Gained an understanding of the function and responsibility of the TAX Tobacco Unit;
- Reviewed laws and regulations governing tobacco enforcement;
- Performed an inspection walkthrough with TAX Tobacco Unit field auditor;
- Analyzed statistics for number of inspections performed and resulting assessments;
- Evaluated TAX Tobacco Unit performance measures and researched related industry standards and best practices;
- Determined other entities with roles in tobacco enforcement in Virginia and documented their responsibilities;
- Evaluated roles and responsibilities for overlap/duplication of effort;
- Researched structure of tobacco enforcement in a sample of other states; and
- Researched studies related to tobacco enforcement in Virginia.

### OBSERVATION NO. 1— TOBACCO ENFORCEMENT DUTIES

TAX and the Office of the Attorney General (OAG) perform similar tobacco enforcement duties as follows:

- TAX and the OAG each conduct reviews of a sample selection of stamping agents.
  - The OAG reviews stamping agent documents to assess the reliability of data on Form AG-1 *Stamping Agent's Monthly Report of Virginia Stamped Cigarettes and Roll-Your-Own (RYO) Tobacco by Non-Participating Manufacturer's (NPMs) Brand Family*

and Form AG-2 *Stamping Agent's Monthly Report of Virginia Stamped Cigarettes and Roll-Your-Own (RYO) Tobacco by Participating Manufacturer's (PMs) Brand Family*. The completed forms report the number of cigarette packs stamped and number of ounces of RYO tobacco for which tax was paid during the month. In some instances, the OAG employees also conduct a site visit during which they tour the facility, interview staff and request additional information or clarification, if needed.

- TAX reviews Forms TT-13 *Monthly Report of Cigarette Stamping Agent* and Forms TT-14 *Monthly Report of Non-Resident Cigarette Stamping Agent* filed by stamping agents. These forms show details of cigarettes stamped and stamp usage during the month. TAX may elect to conduct a stamping agent audit if unusual activity is observed. Activity that may prompt an audit includes failure to file Form TT-13 or TT-14, tax forms reporting no activity, incomplete forms, forms with mathematical errors, and forms showing a high variance of stamping activity from month to month. While conducting an on-site visit, the TAX auditor will review stamp usage, look for counterfeit stamps and contraband tobacco, and analyze records to verify information on Forms TT-13 and TT-14.
- A key reason for OAG to assess the reliability of data on Form AG-1 is because that information can help support the validity of the number of cigarettes and the number of ounces of RYO tobacco sold by a Non-Participating Manufacturer (NPM) and reported on the annual or quarterly *Certificate of Compliance*. An NPM is a tobacco product manufacturer that has not become a signatory to the *Tobacco Master Settlement Agreement* (MSA), an agreement in which 46 states settled their lawsuits against the tobacco industry for recovery of their tobacco-related health-care costs. While PMs must make annual payments to a national escrow agent so funds can be distributed to each state, NPMs are required to place funds annually or quarterly into a qualified escrow account as outlined in [§ 3.2-4201](#) and [§ 3.2-4211](#) of the *Code of Virginia*. The amount of the required escrow deposit is based on the units (number of cigarettes or ounces of RYO tobacco) sold and multiplied by a specified escrow rate. NPMs must annually or quarterly certify to the OAG that they have complied with the escrow deposit provisions by completing and submitting the Certificate of Compliance. The Certificate of Compliance discloses the number of cigarettes and ounces of RYO tobacco sold, the applicable escrow rate and the required deposit amount. TAX's efforts to verify information on Forms TT-13 and TT-14 is beneficial in assessing whether cigarette packs are being stamped, and those tax reports may be used by the OAG to help validate data on Forms AG-1 and AG-2.
- Both TAX and OAG complete the following tasks during inspections of tobacco retailers:
  - Determine that cigarettes are listed on the Virginia Tobacco Directory of approved products;

- Review cigarette packs for a properly affixed Virginia tax stamp; and
- Determine that cigarettes are not marked as “For Export Only” or “Duty Free.”

Both agencies are authorized to review tobacco retailers and stamping agents as detailed in [§ 3.2-4215.1](#) and [§ 58.1-1007](#) of the *Code of Virginia*. While the agencies were aware that the other handled certain oversight duties of the same entities, both were of the opinion that their review focus was different, and neither agency knew all of the specific activities being performed by the other.

At the time of our review, TAX’s Tobacco Unit consisted of five auditors (one of whom is a part-time employee) and a management analyst. The unit is headed by a manager who also oversees the Nonprofit Organizations Unit. Historically, the Tobacco Unit primarily conducted retail inspections and other tobacco products tax reviews. Beginning in 2014, the unit began to conduct sales tax audits in an effort to reduce fraudulent use of sales tax exemption forms by purported retailers purchasing cigarettes without paying sales taxes. In calendar years 2015 and 2016 (through November 3), the Unit had conducted 267 and 297 sales tax audits, respectively. Some of these sales tax audits would have also involved retail inspection and/or other tobacco products tax review procedures. These sales tax audits resulted in assessments totaling approximately \$8.2 million in 2015 and almost \$6 million in 2016. During those two years, the unit made four assessments for other tobacco products tax totaling approximately \$2,700. While the Tobacco Unit reviews monthly reports submitted by stamping agents, TAX did not conduct any on-site reviews of stamping agents those two years because staff resources were focused on sales tax audits. The Tobacco Unit manager stated that they have not encountered any issues during stamping agent reviews for the past five years.

The OAG Tobacco Enforcement Unit (TEU) consists of the following staff: two attorneys who handle manufacturer certifications and escrow issues, among other tasks; four investigators who conduct the retail inspections and complete other types of investigations; three auditors who handle the stamping agent audits and site reviews; and an administrative coordinator. The OAG TEU director stated that in 2015 they conducted 1,724 retail inspections and seized 4,735 packs of cigarettes. For 2016, they completed 1,685 retail inspections and seized 715 packs. Data for stamping agent audits and reviews was not readily available.

The impact of having similar duties handled by employees of two agencies may result in duplicate efforts and an inefficient use of resources (for employee time and travel costs).

**Recommendation**

TAX should work with the OAG to identify areas in the stamping agent review and retail inspection processes where resources could be leveraged to avoid duplication of effort while maintaining effective oversight.

TAX's retail inspection processes include three of the four tasks performed by the OAG, and TAX employees must visit retailers to review sales tax and other tobacco products tax records. Consider having TAX address only stamp and tax-related issues during the retail inspections, and having the OAG solely review for contraband products and determine that products are not marked "Duty Free." Also, the agencies should implement a process to inform each other of completed or planned retail inspections so they can avoid duplicate inspections within a defined timeframe.

Stamping agents are required to send different forms monthly to TAX and the OAG. These forms do not contain identical data, and the similar data is aggregated differently so it may not be feasible to assign inspection responsibility to one agency. However, the two agencies may benefit from a process for conducting joint reviews of stamping agents that will enable each agency to sufficiently validate reported information while using fewer resources.

### **Management Response**

While TAX agrees it is accurate that the two units do review similar items during their inspections, they review for different reasons. Because of limited resources and budget constraints, it is critical for the Tobacco Unit and OAG personnel to perform comprehensive reviews within their authority to assure compliance. The two departments are in contact with each other as it relates to retail inspections. On numerous occasions the Tobacco Unit has contacted OAG personnel about contraband cigarettes since the Tobacco Unit is not authorized to confiscate cigarettes. And, the OAG has contacted the Tobacco Unit concerning OTP issues. This combined effort has provided a presence within the Commonwealth by the two agencies resulting in an increased compliance with tobacco regulations. In addition, currently all billing for code violations is administered by the Tobacco Unit for both the Tobacco Unit and OAG. This enhanced communication has led to an improved working relationship over the last two years. TAX concurs that it will continue to work with the OAG to leverage resources and processes.

### **OBSERVATION NO. 2— NO COMPREHENSIVE LIST OF TOBACCO RETAILERS**

TAX does not have a comprehensive list of all tobacco retailers in the Commonwealth of Virginia. The number of retail businesses that sell tobacco products in Virginia is unknown because TAX currently does not have a process in place to capture and track such information.

Various sections of the *Code of Virginia* empower TAX to enforce sales and use tax, cigarette tax and other tobacco products tax laws. A summary of such laws includes the following:

- [§ 58.1-633\(A\)](#) – Every dealer required to pay or collect sales and use tax shall keep suitable records of the taxable sales, leases or purchases as may be necessary to determine the amount of tax due, and such other pertinent information as may be required by the Tax Commissioner.
- [§ 58.1-1007](#) - Every person receiving, storing, selling, handling or transporting cigarettes shall preserve all invoices or other documents relating to the purchase, sale, exchange, receipt, or transportation of all cigarettes for a period of three years. All invoices and records shall be subject to audit and inspection at all times by an authorized representative of TAX.
- [§ 58.1-1016](#) – TAX shall administer and enforce the cigarette tax. A Department Agent or representative shall have the power to enter upon the premises of any person to examine any books, records, invoices, etc., bearing upon the amount of taxes payable.
- [§ 58.1-1021.04:2\(B\)](#) – Authorized agents or employees of TAX may enter any place of business of a distributor during usual business hours and inspect the premises, the records required to be kept, and the tobacco products contained therein to determine whether the distributor is in compliance with all provisions of the tobacco products tax article.

Auditing and enforcement efforts are more difficult when there are an unknown number of retailers who sell tobacco products. Compliance with the above statutory requirements cannot be assured if TAX does not have a complete population of tobacco retailers.

TAX has not developed a list of tobacco retailers partly because there has been no statutory reason to track them, such as a law requiring that tobacco retailers obtain a state license to sell tobacco products. While Form *R-1 Business Registration Form* was revised four to five years ago to include a checkbox for a business to indicate if it will be selling tobacco products, TAX has no systemic tracking of this checkbox data. Even if such data were tracked, the list would not include businesses that registered prior to the Form R-1 revision, or those that later decided to sell tobacco products.

The absence of a comprehensive list of tobacco sellers results in several potential impacts:

- TAX may overlook or be unaware of retailers who fail to report, or underreport, cigarette sales and sales taxes. Such retailers may also sell cigarettes or OTP for which the applicable excise taxes have not been paid. Auditing and enforcement are more difficult when tobacco retailers are unknown.
- TAX is unable to determine the percentage of applicable businesses that the Tobacco Unit has reviewed or inspected in a particular year. This percentage of “audit coverage” can be a useful measure to assess the degree to which the agency is achieving its established audit coverage goals necessary to obtain effective enforcement of the tax laws.
- Other state agencies must undertake additional efforts to complete their tobacco enforcement duties. The Department of Behavioral Health and Developmental Services (DBHDS) must manually compile a population of tobacco retailers for use by the

Department of Alcoholic Beverage Control (ABC) in scheduling underage buyer checks and advertising and labeling compliance inspections on behalf of the U.S. Food and Drug Administration and the DBHDS. To develop this list, the DBHDS collaborated with Community Services Boards (CSBs) in 2016. CSB employees drove every primary and secondary road in their catchment area and listed all tobacco and vape businesses. The (OAG) Tobacco Enforcement Unit also uses the DBHDS list to select retailers for inspections.

### **Recommendation**

TAX should develop a method to capture and compile a comprehensive list of tobacco retailers that would be available for use by all agencies with tobacco enforcement responsibilities.

### **Management Response**

TAX agrees that it does not have a comprehensive list of all tobacco retailers in the Commonwealth of Virginia and does not have a process in place to capture and track such information. However, with the passage of [HB 1913](#) and [SB 1390](#), as of January 1, 2018, the Tobacco Unit will have the necessary information to create and maintain a comprehensive list of wholesalers and retailers purchasing cigarettes. Tax concurs that a method to capture and compile a comprehensive list of tobacco retailers that could be available for use by all agencies with tobacco enforcement responsibilities should be developed. Tax will share information where appropriate as authorized by Code of Virginia § [58.1-3.2](#): Attorney General's and Tax Commissioner's authority to request and share information.

## **OBSERVATION NO. 3— TOBACCO UNIT INTERNAL PERFORMANCE MEASURES**

TAX Tobacco Unit captures various data such as number of inspections, dollar amount of inspections and time spent on individual auditors' daily work activities to be used in evaluating overall performance in meeting agency or unit goals. However, the process lacks a comparison to standards or benchmark targets to objectively evaluate the unit's performance. Additionally, the two primary measures (number of inspections and dollar amount of assessments) may not be the most appropriate metrics for assessing the unit's effectiveness. Therefore, management cannot be assured that it receives the most useful information to inform operational decisions.

Performance measurement is an ongoing process of ascertaining the degree to which an organization is achieving its goals and objectives. Performance measures are developed as standards for assessing the extent to which these objectives are achieved. Performance management includes a determination of the appropriate level of performance and an assessment of the actual performance against the desired level.

The current method of evaluating performance by focusing on inspections and assessments was used to readily identify sales tax audit results. This method began in 2014 due to reports of increased cigarette trafficking activity. The data provided to management each week shows the inspections and assessments for the overall unit as well as amounts attributable to each tax auditor. The unit's inspections and assessments for calendar year 2015 and 2016 are listed in the table below:

<b><i>Tobacco Unit Data*</i></b>	<b><i>2015</i></b>	<b><i>2016 (through 11/3/16)</i></b>
Number of Auditors	5	5**
Number of Inspections	267	297
Number of Assessments	82	73
Amount of Assessments	\$8,218,183	\$5,985,208

*\*- Retail Inspections were also conducted during some of these sales tax audits.*

*\*\*- One auditor went from full-time to part-time status in 2016.*

Performance measures that do not reflect the organization's goals result in information that is not critical to the entity's success and is of minimal use to management. Also, properly selected performance measures which are not compared to standards or targets provide no basis on which management can evaluate performance. Both situations may lead to inaccurate management conclusions regarding organizational performance. As a result, process improvements may not be implemented when warranted, or unnecessary changes may be implemented.

### **Recommendation**

Tobacco Unit management should determine which performance measures would be most appropriate for the goals and objectives of the office. Once measures have been identified, management should periodically prepare a documented comparison of actual measures to standards or targets to assess performance. Such reviews can identify areas requiring management attention for improvement, or may indicate unrealistic standards or goals that need revision. Several performance measures were discussed with TAX management for consideration.

### **Management Response**

While acknowledging that Code of Virginia [§58.1-202](#) (13) charges the TAX Commissioner to ensure that employees of the Department are not paid, evaluated, or promoted on the basis of the amount of assessments or collections from taxpayers and that any performance measure established would need to comply with this requirement, TAX agrees with the condition observed. TAX concurs that internal performance measures which would be most appropriate for the goals and objectives of the unit in measuring program success should be evaluated and implemented.