DEPARTMENT OF REVENUE

TAX DISCOVERY PROGRAM

ACTION STEPS TO INCREASING REVENUE AND IMPROVING TAX COMPLIANCE

CITY OF PHILADELPHIA

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May 20, 2009

Mr. Keith Richardson, Commissioner
Department of Revenue
Municipal Services Building, 6th Floor
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102-1679

Dear Commissioner Richardson:

Pursuant to Section 6-400 (d) of the Home Rule Charter, the City Controller's Office has performed an assessment of the Department of Revenue's tax discovery efforts. We performed this assessment to compare policies and procedures employed by the department's Tax Discovery Unit to industry "best practices." A synopsis of the results of our work is provided in the executive summary to the report.

We discussed our findings and recommendations with you and your staff at an exit conference and included your written response to our comments as part of the report. We did not audit the written response and, accordingly, we express no opinion on it. We believe that our recommendations, if implemented by management, will improve the effectiveness of the Department of Revenue's tax discovery efforts. Our recommendations have been numbered to facilitate tracking and follow-up in subsequent years.

We would like to express our thanks to you and your staff for the courtesy and cooperation displayed during the conduct of our work.

Very truly yours,

ALAN BUTKOVITZ
City Controller

cc: Honorable Michael A. Nutter, Mayor
Honorable Anna C. Verna, President
and Honorable Members of City Council
Members of the Mayor's Cabinet

Tax Discovery

Executive Summary

Why the Controller's Office Conducted the Examination

Concerned about the City of Philadelphia's (City) growing budget deficit, the Office of the Controller initiated this review to identify opportunities for generating "new" revenues through tax discovery. Simply stated, tax discovery is the collection of methods used to identify taxpayers not filing tax returns or paying their fair and appropriate share of taxes. In a broader context, tax discovery is a revenue enhancement technique with two underlying objectives: (1) to generate "new" sources of revenue without increasing taxes, and (2) to maintain voluntary compliance in the future.

What the Controller's Office Found

Significant numbers of businesses appear to be evading city taxes and thus contributing to the size of the City's "tax gap." Limited tax discovery work performed by the Controller's Office revealed that close to 60% of the businesses advertising home repair and remodeling services in one center-city newspaper had no license to conduct business in the City. Moreover, within the construction industry sector, contractors and their subs may not be paying City wage taxes of between $2.1 million - $7.4 million annually.

The Department of Revenue's (DOR) initiatives to stem tax evasion and reduce the City's "tax gap" have been severely limited, by what management asserts are resource shortages. Our work identified 10 "best practices" to enhance the City's tax discovery efforts. We gathered these 10 "best practices" by researching the tax discovery practices used by the IRS, other state and local governmental tax agencies, and private entities offering tax discovery services. While the DOR had partially employed some of the practices, we believe adopting and / or fully implementing more of them could yield improved tax compliance and less tax evasion. Some of the more significant observations we made during the audit include the DOR's:

- inadequate planning and documentation of the logic it uses to decide which tax discovery initiatives to employ.

- limited focused tax discovery initiatives that concentrate almost exclusively on resident individuals failing to report City Wage Taxes, file School Income Taxes, or Business Privilege and / or Net Profits Taxes.

- limited campaign to proactively educate the general public and / or the less sophisticated taxpayers who may lack initiative to become knowledgeable about City taxes.

- failure to tie its tax discovery initiatives to specific measurable goals that can then be evaluated for success or failure.

What the Controller's Office Recommends

The Controller's Office has offered a number of recommendations to the DOR. Some of the more significant recommendations include: (1) utilizing documented data analysis to develop a strategic plan, which maximizes the use of limited staff; (2) constructing a data warehouse that will aid in providing better data analysis; (3) doing more data-mining activities to identify tax evaders; (4) expanding the current taxpayer educational program to encompass more proactive community outreach; and (5) measuring the results of tax discovery initiatives.

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Background

In recent years, the Internal Revenue Service (IRS) and others have written much about the concept of "tax gap," which is generally associated with taxpayer compliance with federal tax obligations. The IRS uses the concept to measure the extent to which taxpayers do not file their tax returns or pay the correct tax on time. In other words, it is the difference between what taxpayers legally owe and what they voluntarily pay. The IRS estimates the federal "tax gap" at $345 billion for all types of federal taxes.

While frequently linked to federal taxes, the concept of "tax gap" also has significance to local governments. The City of Philadelphia (City), for example, has several self-assessed taxes that it levies on taxpayers, such as the Business Privilege Tax, Net Profits Tax, and the School Income Tax (see Appendix II for a complete list of City taxes). All these tax types rely on taxpayers to voluntarily report their income, apply the appropriate tax rate against this income, and remit the amount owed when due. Additionally, while not of the same self-assessed nature, both the city wage tax and the earnings tax depend on employers voluntarily reporting employee wages and remitting the withheld taxes on these wages to the City.

Philadelphia's Finance Director reported that for the fiscal year ending June 30, 2008, the City collected $3.2 billion for all tax types combined. However, at issue is not what amounts the City collected, but rather what amounts taxpayers legally owed and did not pay — either because they failed to file a return, underreported taxable income, or simply did not pay the full amount due.

Unlike the IRS, Philadelphia has not studied or estimated the potential tax gap involving City taxes. In general, at the local level, one expert[1] estimates 27 percent of the potential taxable entities that should be filing local-level tax returns and paying taxes are unregistered and therefore unknown to the local taxing authorities. Another 16 percent of registered entities are either fully or partially noncompliant with their local tax obligations. Both types of entities — the unknown and the noncompliant — contribute to the size of the tax gap.

[1] Jeffrey Turrow, PhD, President, TMA, Inc. Simi Valley, California.

A key process to reducing the tax gap is tax discovery. Simply stated, tax discovery is the collection of methods used to identify taxpayers not filing tax returns and paying their fair and appropriate share of taxes. In a broader context, however, tax discovery is a revenue enhancement technique with two underlying objectives: (1) to generate “new” sources of revenue without increasing taxes, and (2) to maintain voluntary compliance in the future.

Tax discovery efforts of the City fall under the authority of the Department of Revenue (DOR), a department created under section 3-100(d) of the 1951 Home Rule Charter. The DOR reports directly to the City’s Director of Finance and consists of five major divisions: Revenue Collection, Revenue Enforcement, Tax Discovery, Water Revenue Collection, and General Support. Although tax discovery can arise out of enforcement (for example, in the course of an audit, department revenue examiners may determine that taxpayers underreport revenue, which correspondingly results in the discovery and assessment of additional tax liability), the principal efforts dedicated to identifying non-filers falls under the control of the DOR’s Tax Discovery Unit, a unit composed of 20 employees.

REVENUE DEPARTMENT CAN IMPROVE ITS PROGRAM FOR TAX DISCOVERY BY ADOPTING SOME BEST PRACTICES

We identified 10 "best practices" for effective tax discovery. We divided these practices into the following categories for purposes of simplicity and organization in this report section.

- Planning
- Execution
- Follow-up and Results

The City's DOR has implemented very limited tax discovery initiatives. These initiatives are focused principally on certain income classes for resident individuals, effectively missing all income from nonresident individuals and all business entities including pass through entities such as trusts, partnerships, and Subchapter S corporations.

We have collected the following "best practices" information from the IRS, as well as various state and local governments such as the states of Pennsylvania, California, and the cities of New York, NY, and Los Angeles, CA. We also identified "best practice" ideas from the discovery services of some private sector companies. None of the organizations we contacted employs all of the "best practices" enumerated below, however, we have concluded that if the Revenue Department implements at least some of the practices we have identified, it will aid the department in maximizing revenue collections and thus contribute significantly to reducing current budget deficits projected by the administration. For a summary of the practices we identified, see Appendix III.

BEST PRACTICES FOR PLANNING TAX DISCOVERY

"Best Practice" — Develop a Data Driven Strategic Plan

The Deputy Director for the Washington State Department of Revenue has said, *"Without better information, we are destined to do the same thing, year after year, without knowing if we are making a difference."* Our research and discussion with other tax administration agencies suggests that data analysis plays a key role for them in planning targeted tax education, selecting tax compliance audits, and identifying areas for tax discovery.

IRS stands at the leading edge of using data analysis. It believes data analysis allows the legislative and executive branches of the federal government to make better decisions about tax policy and the allocation of resources for tax administration. Not only has IRS estimated the total tax gap as $345 billion, but also the agency has dissected components of the gap into three major categories (nonfiling - $27 billion; underreporting - $285 billion; and underpayment - $33 billion). IRS further examined the underreporting component and estimated the composition by major tax types (individual income tax - $197 billion; employment tax - $54 billion; corporation income tax - $30 billion; estate and excise taxes - $4 billion), and within tax type by underreported class of income (or overstated adjustment, deduction, exemption, and credit) payroll-tax type, or corporation size (large or small).

Armed with the above information, IRS developed a comprehensive strategy to reduce the gap. The strategy included legislative changes, as well as better-targeted enforcement and increased outreach efforts to help taxpayers understand their obligations.

Of other tax agencies we surveyed, California and Washington stood out as leaders in using data analysis to drive the focus of their tax discovery efforts. California, for example, quantified its state income tax gap at $6.5 billion annually. It looked at trends identified by the IRS and made assumptions about how these trends might apply to the state. It had determined that 43 percent of non-filers were wage earners. Knowing wage earners made up a significant percentage of non-filers, California's tax agency contacted the state-level Employment Development Department and shared that department's "New Employee Registry." As a result, the tax agency routinely began identifying and garnishing wages of delinquent taxpayers soon after they started a new job.

The state of Washington used data analysis to identify potentially 86,000 personal services firms that were not paying an estimated $24 million in use tax. This knowledge drove the Washington State Department of Revenue to strategize a two-phased plan that included a special educational notice about the tax, and then a more personalized follow-up letter with an interactive voice mail system established so taxpayers who owed no use tax could respond.

Findings

The DOR has not used data analysis to formally develop and adopt a strategic plan for tax discovery. We observed no analyses documenting the types of taxable entities, sorts of industries, or other categorizations that may comprise the City's tax gap. Quantifying the City's tax gap was not within the scope of this audit project, and accordingly, we did not do so. However, a recent study (see Appendix IV), conducted by the Controller's Office Financial Policy and Analysis Unit, and focusing solely on Philadelphia's construction sector, suggests there are significant numbers of construction workers operating in an "informal economy" who are evading city wage taxes. The Unit estimates that lost wage taxes associated with this single sector of the "informal economy" amount to between $2.1 million and $7.4 million.

The manager of the Tax Discovery Unit indicated that the DOR's discovery efforts deal almost exclusively with identifying City residents who do not pay wage taxes, underreport their income for School Income Tax purposes or fail to file their business taxes if self-employed. Little time is devoted to corporations, partnerships, or other pass-through entities. Similarly, the Discovery Unit spends only a small amount of time detecting nonresident individuals or businesses performing work inside the City's physical boundaries, but paying none of the required taxes. The manager indicated this limited focus of tax discovery efforts was due to staff shortages.

Given the strain on existing resources, we then believe it is absolutely imperative to utilize department resources as wisely as possible to maximize results. In our opinion, the first step in accomplishing this goal is to use data analysis to identify the size of the task at hand — in this case the potential components of the tax gap — so as to determine how best and how much, in terms of the level of expenditure, should be directed towards reducing each component.

<u>Recommendations</u>

We recommend that DOR management use documented data analysis to develop a strategic plan and drive decision-making about tax discovery efforts [3608.01].

"Best Practice" — Build a Data Warehouse Useful for Performing More Varied and Meaningful Analyses

To perform data analysis effectively, many agencies have built their own data warehouse. Simply stated, a data warehouse is a collection of joined databases from multiple and usually varied sources into one comprehensive and easy to manipulate database. A data warehouse allows tax agencies to transform large volumes of raw data into useful subsets of information that can help make better planning decisions. The Washington State Department of Revenue uses its data warehouse for several purposes, some of which include: determining problem industries, identifying other registered accounts at the same address, identifying under-reporting accounts, identifying unregistered or non-reporting accounts, and tracking businesses in like industries.

In addition, some municipalities and states have entered into consortiums for the sharing of data between each other. This innovative program permits each member of the consortium to observe more business entities and gather a more complete picture of each business entities' operation.

Findings

DOR management has indicated it uses data files obtained from the IRS to do most of its tax discovery initiatives, which include identifying individual non-filers of wage and school income tax. Only recently has it begun to seek out sources of information from the other sources. For example, it has begun talking with representatives of Commonwealth of Pennsylvania, which maintains databases of new business registrations, taxpayer audit results, and the outcome of its own tax discovery efforts. And recently, on a very limited basis, the DOR has begun to explore the usefulness of databases owned by other City agencies. The City's Department of Licenses and Inspections for example, has a database that includes a wealth of information about business licenses, as well as names and addresses associated with properties it inspects for building and electrical code violations.

The DOR has not exchanged nexus[2] data with other state and local governments in the region. Philadelphia is contiguous to two states and three wealthy counties, all of which are hubs to dynamic business firms. Many of the business entities share workspace in both the City and a neighboring area, while almost all others participate or enjoy some business amenities based on their proximity to Philadelphia. Business activities subject to Philadelphia's taxes are those activities conducted within the City. Currently, these activities can be difficult to both discover and prove without substantial assistance by the business entity. In our opinion, acquiring nexus data for use in a data warehouse would enhance DOR's ability to identify leads for follow-up activities including, for example, on-sight visits or mailings.

[2] In the context of City taxes, "nexus" is the connection required to exist between the City and a potential taxpayer such that the City has the right to impose a tax. For a taxpayer located outside Philadelphia, but doing business activities within its boundaries, the City has the right to tax the revenues and / or profits generated from those activities.

Recommendation

We recommend that the DOR continue to identify sources of data that will prove useful in tax discovery efforts. Using the data that it identifies, the DOR should begin building a data warehouse. Such a warehouse of information can provide more opportunities for varied analyses. If constructing a data warehouse internally proves too daunting, the department should consider engaging outside expertise [3608.02].

BEST PRACTICES FOR EXECUTION OF TAX DISCOVERY

"Best Practice" — Use Data Mining Technology to Identify Tax Evaders

Data mining is the process of analyzing data from different angles and summarizing it into useful information. It is designed to explore typically large amounts of business or market-related information in search of consistent patterns or systematic relationships between variables. Used by the IRS and various state tax administrative agencies to identify tax evaders, data mining is considered a relatively new trend. Some states such as California, Massachusetts, and Washington have been using data mining techniques since the late 1990's. In Massachusetts, for instance, the state taxing agency there scans a U.S. Customs and Border Protection database of people who paid duties on big-ticket items entering the country. Anyone who fails to pay the state the required 5 percent "use tax" gets flagged. Massachusetts has also compared state motor vehicle registration data against tax returns, looking for people who might be driving expensive luxury cars such as Rolls Royces or Jaguars, but declaring only a small income.

Findings

Since 1997, the Revenue Department's Tax Discovery Unit has used an IRS software program entitled STAX (State Tax Automated Compliance System Software) to identify delinquent taxpayers. The STAX software allows the Revenue Department to compare IRS data against information in the department's own TIPS (Taxpayer Information Processing System) database, searching for Philadelphia residents who, for example, might have reported wages, on their

Federal 1040 return, but did not pay or have an account number for their City wage or earnings taxes.

Additionally, our work disclosed that, independent of the DOR, the City's Law Department has engaged an outside vendor to provide delinquent tax collection and, to a limited degree, some tax discovery services. The Law Department exclusively monitors the contract and approves vendor payments, which are based on a percentage of collected taxes. The Law Department reported that the vendor's tax discovery efforts generated $19 million and $8 million for fiscal years 2008 and 2007, respectively. However, department representatives asserted they would have to do research to provide us with details of the discovered taxpayers.

DOR managers told us that the Law Department has not been providing them with information about the operating results of the contract. Until we advised them, they had no knowledge of what tax discovery amounts the vendor had collected; nor had they any first-hand knowledge of the specific taxpayers that the contractor had identified.

To illustrate the potential of data mining as a source of leads for unlicensed businesses (and possibly unreported revenues subject to City taxes) the Controller's Office Fraud Special Investigation (FSI) Unit manually scanned the advertising section of one issue of a local newspaper,[3] searching for individuals and businesses offering home repair and remodeling services in Philadelphia. In just a single issue, the unit identified 193 businesses advertising their services in the paper, several of these businesses appeared to be located outside Philadelphia. The FSI Unit queried the Department of Licenses and Inspections' (L&I) Hansen System[4] for evidence of whether the businesses had a Business Privilege (BP) License on file. Investigators observed that of 193 home repair and remodeling businesses advertising in the newspaper, 112 (58%) of them had no record of a BP license on file. Consequently, there is also a high probability that the businesses are not filing Philadelphia tax returns. We estimate that lost revenue to the City, as a result of these businesses alone failing to obtain a BP License, is approximately $33,600. Moreover, we believe that scanning other local newspapers could yield similar leads worth following up.

[3] Investigators used the September 12, 2008 edition of the Philadelphia Gay News, a center-city newspaper with a current circulation of nearly 20,000 readers.
[4] The Hansen System is a proprietary data system used by L&I to manage all its transactions with citizens, including the acquisition of BP Licenses.

In response to the FSI findings above, the DOR has indicated that it too performs this type of data mining activity and has had good results.

Recommendations

To expand the DOR's current level of data mining activity, we recommend management pursue the following course of actions:

- Continue using IRS data to search for City tax evaders. However, the department should undertake additional data mining activity, especially if it can construct a data warehouse as we suggested in our recommendation section for the previous "best practice" [3608.03].

- Until more sophisticated data mining efforts can occur, continue to regularly scan local newspapers and telephone directories (such as the yellow pages), searching for businesses that may not be licensed to operate within Philadelphia [3608.04].

- Advocate City legislation to require that businesses advertising in Philadelphia newspapers and telephone directories include their business privilege license numbers [3608.05].

- Research vendors that have developed their own warehouse databases for tax discovery, and, in lieu of performing in-house data mining, consider outsourcing it. Many of these vendors have amassed large databases from existing lists such as telephone directories, media news and advertising lists, as well as real property records. Frequently, discovery companies will train the tax agencies' staff in the electronic discovery methods they themselves employ. This practice helps ensure continued future strategies for uncovering tax evaders[5] [3608.06].

- Meet with representatives of the Law Department to discuss the data mining capabilities of the vendor currently contracted to collect delinquent taxes. Management should request that the DOR assume the oversight role of any tax discovery work, so that it can provide more strategic coordination and

[5] This recommendation should be done in conjunction with the one that immediately follows.

supervision. The Law Department should confine its contract to tax collection activities [3608.07].

"Best Practice" — Utilize a "Tax Clearance" System to Encourage Payment of Outstanding Tax Liabilities

To encourage delinquent taxpayers to pay their outstanding city tax and other liabilities, Washington DC requires businesses seeking a permit or license to obtain a "Clean Hands" certification, which provides that an applicant for a license or permit cannot owe more than $100 (in taxes or other liabilities) to the District government. The applicant, through the agency responsible for issuing the permit or license, submits a "Clean Hands" certification to Washington DC's Office of Tax and Revenue (OTR). OTR then researches each application through its computer system for any accounts receivable owed in aggregate of $100 or more. If OTR finds outstanding receivables, it notifies the agency from which the applicant is seeking a license or permit and that agency in turn denies the request. Likewise, the Commonwealth of Pennsylvania has recently begun a similar "tax clearance" initiative, which reportedly has resulted in increased revenues via the collection of delinquent taxes.

Findings

Philadelphia does not have an identical type "Tax Clearance" System, but it does require anyone requesting building permits to submit the name and City license number of the prime contractor chosen to perform the work. The City's Department of Licenses and Inspections (L&I), the agency responsible for granting permits to do the project, performs searches to determine if the contractor scheduled to do the project has a Business Privilege License. If no license is found, L&I will not grant the contractor permission to commence the project. However, the process could be enhanced and made more effective if the search extended to identifying a contractor's current tax status. Currently, if a contractor owes a significant amount of taxes to the City, he or she may still be allowed to proceed. Furthermore, L&I's process fails to encompass subcontractors on the project. These individuals or companies may be unlicensed and owe the City taxes too.

In addition, the City's DOR electronically generates daily exception runs of vendors doing business with Philadelphia government that either have no Business Privilege License or have tax and other outstanding liabilities due. This enforcement method has increased compliance and business tax collection. The City's Law Department is also expanding an existing program that threatens to revoke existing Business Privilege Licenses for non-payment of City taxes.

Recommendations

The City should consider expanding its "Tax Clearance" System beyond just contractors performing code specific projects for the public or vendors doing business with the City of Philadelphia government. The DOR should meet with L&I and to the extent possible, coordinate a process that extends the search for business licenses to project subcontractors. The DOR should also coordinate procedures that will include searching for any open tax liabilities due the City, as well as broadening the system to include all businesses and/or individuals seeking any type of license or permit from the City [3608.08].

"Best Practice" — Use a Fraud Hotline / Whistleblower Program

Programs that provide a hotline or other mechanism, which the public can use to report individuals or businesses that have failed to file tax returns, or have intentionally submitted inaccurate or incomplete information are used by several government agencies. The IRS has had a whistleblower program for years and offers cash rewards (up to 30 percent of the additional tax, penalty and other amounts it collects) to those who provide specific and useful information on tax cheats. Of the tax agencies we contacted, most had fraud hotlines, but only Los Angeles offered a cash reward. Other agencies appear to offer whistleblowers the satisfaction of helping to fight against tax evaders to ensure that all businesses and individuals pay their fair and appropriate share.

Findings

Philadelphia's DOR has had no tax fraud hotline or whistleblower programs. However, in December 2008, the Revenue Commissioner announced that his department was exploring the effectiveness of offering rewards to individuals who submit tips to a tax fraud hotline to be established some time in fiscal year 2010.

We believe a tax fraud hotline is another tool for identifying tax evaders. In our opinion, a hotline can increase the incentive for taxpayers to self-report, especially when detection appears likely. Moreover, we also believe that publicizing the hotline increases public awareness of the City's tax gap and efforts being made to close it. A hotline that offers cash rewards, should be even more effective.

Of 14 tips about contractors operating without appropriate licenses that the Controller's Office received and investigated as part of this project, we substantiated five (over one-third) as true. As a result of investigating these tips, five contractors now appear on the City's tax rolls and should remain on the DOR's radar screen.

<u>Recommendation</u>

We encourage the DOR to pursue implementation of a fraud hotline or whistleblowers program, especially one that might offer cash rewards [3608.09].

"Best Practice" — Encouraging Voluntary Compliance through Education

One tax discovery consultant to whom we spoke indicated "…discovery identifies and educates those who are not aware." The consultant implied that when taxpayers are ignorant of the law, most likely the agency has failed to educate them adequately. He recommends that tax administrators consider use of a combination of call, direct mail, and media campaigns for a more proactive approach to encouraging voluntary compliance.

In 2002, Los Angeles started an extensive outreach program through television, radio, print media, and inserts in utility bills to inform businesses and residents of the registration requirements for conducting business activities. It also conducted a targeted mailing campaign to 151,000 businesses thought to be operating in the city, but having no tax account on record. Through November 2004, Los Angeles reportedly had 45,000 newly registered businesses, which in turn generated more than $20 million in new business tax revenues.

Many tax agencies publish significant amounts of information about taxes on their web sites. This information includes everything from descriptions of the taxes and tax rates to forms needed for compliance. One of the most intriguing web sites we viewed was for the state of Washington. That site not only provided an abundance of industry specific tax guides, but allowed viewers to view the guides in several different foreign languages, thereby reaching out and enlightening many foreign speaking individuals that may have opened small businesses.

Findings

The City's DOR does have an education program, but the program is geared principally to reaching influential parties in professional and business circles, such as tax practitioners and attorneys. And, while the DOR does targeted mailings, they are done as an after-the-fact enforcement effort, rather than a proactive endeavor to encourage voluntary compliance. Except for the City government cable channel, little is done using television, radio, print media, or mail inserts to proactively educate the general public and / or the less sophisticated taxpayers who may lack initiative on their own to become knowledgeable about City taxes.

As to publishing tax information on the web, the DOR has developed a very user-friendly and comprehensive web site that provides taxpayers and practitioners with helpful information about City taxes and filing requirements. For example, taxpayers can download needed tax forms and instructions, apply on line for tax account numbers, and obtain all technical rulings and tax regulations. The DOR's web site, however, is only presented in English and therefore does not avail itself to foreign speaking individuals who may reside in the City

<u>Recommendation</u>

We recommend that the DOR consider expanding its current taxpayer educational program to encompass more proactive community outreach efforts. The department should consider encouraging voluntary compliance through increased public awareness by:

- expanding even further its practice of sending letters to targeted potential taxpayers — for instance, regional contractors and other service providers situated just outside of Philadelphia that are likely to perform work within the City[6] — explaining Philadelphia's tax requirements and the ramifications of failing to file City tax returns [3608.10].

- airing television and radio commercials to the general public along with placing advertisements in local newspapers and

[6] Such taxpayers may be identified through a variety of methods that include, for example, data mining and street observations.

printing brochures and pamphlets that can be enclosed in utility bills [3608.11].

- making the DOR web site more user friendly for foreign speaking citizens that may be subject to tax regulations of Philadelphia [3608.12].

“Best Practice” — Conduct “Street-Level Observations”

A successful tax discovery campaign should include periodic unannounced “street-level observations.” Such observations serve to identify unlicensed or “cash-only” business operations. Both Seattle, WA and Chicago, IL employ this practice in their discovery operations. Seattle, for example, conducts building sweeps searching for unlicensed businesses. Inspectors also look for unlicensed amusement devices (subject to amusement taxes) in taverns and check closed businesses for unlicensed successors. Similarly, Chicago’s Department of Revenue auditors frequently use “street-level observations” as a tool to discover cash-basis businesses. That city has recently expanded its investigatory staff from thirty to over one hundred field investigators. Following this initiative, a representative of the Chicago DOR stated that 2008 had been an exceptional year for voluntary disclosure by new tax registrants, resulting he believed, from the increased focus on field investigations.

Findings

Staff shortages have been a major obstacle to moving the DOR’s investigators back out onto the street for tax discovery, according to the department’s investigations manager. The shortage in staff within other DOR units has created the need for investigators to take on many “in-house” duties. Often in the past, DOR investigators would go out to a construction job site of an approved contractor and solicit the identity of all subcontractors to determine if the subcontractors were registered in Philadelphia. When investigators found subcontractors not registered, they would assist them in becoming registered.

In our opinion, routine and targeted “street-level observations” can be an effective tool for closing the tax gap if used in conjuction with other “best practices” identified in this report. For instance, a recent unscientific sweep of nearly 200 businesses conducted by the Controller’s Office FSI Unit disclosed over half-a-dozen businesses that were operating without a BP License.

Recommendations

To the extent possible, we recommend that the DOR:

- conduct both routine and targeted street-level observations [3608.13].

  During the exit conference, the DOR management informed us that, subsequent to our fieldwork in this area, its investigation unit has once again become fully staffed. This will enable the DOR to do more street-level work.

- open lines of communication with other City agencies that routinely have employees on the streets performing various city services. For instance, the DOR should meet with agencies such as the Department of Licenses and Inspections, the Streets Department, or the Philadelphia Water Department and provide a methodology for City employees to contact appropriate DOR personnel if they observe suspicious or questionable business operations (for example, a contractor that appears to be providing services in the City, but whose vehicle has a New Jersey license tag or displays a non-city address or phone number) during the performance of their regular work duties [3608.14].

To promote a spirit of intragency cooperation among City departments, the Controller's Office, through its FSI Unit, has formed a working group relationship with members of the the DOR's Tax Enforcement Unit, as well as inspectors from the Department of Licenses and Inspections. The group has established a formal process, including feedback and cross flow of information, for dealing with tips or complaints about contractors and their subs suspected of not having the appropriate licenses to do business in the City and / or not withholding City wage tax from their employees. In addition, the working group continues its efforts to identify other ways of improving the process, placing emphasis on the discovery of tax evasion while it is occurring instead of after the fact.

"Best Practice" — Develop Leads for Non-filers As Part of Tax Compliance Audit Function

The search for unregistered taxpayers ought to be a routine procedure conducted as part of every tax compliance audit. As part of the audit work, revenue examiners should review and analyze auditee contract relationships with third parties, including their vendors. Tax auditors for the City of Seattle, WA, for instance, conduct what its management refers to as the "package audit." The "package audit" approach requires Seattle's tax auditors to identify potential unlicensed taxpayers routinely as part of their audits. Once auditors identify potential unregistered taxpayers, they validate the fact and follow-up by contacting the taxpayers to gain an understanding of their business activities. Auditors make a decision based on the Seattle tax code; if subject to business license and tax requirements, they secure financial data from the unlicensed taxpayer and prepare a tax assessment.

Findings

The City's DOR auditors do follow best practice to some extent. We were informed that as part of a tax compliance audit, DOR auditors routinely research auditee subcontractors to identify those that may not be licensed to do business in Philadelphia. When auditors discover an unlicensed taxpayer, the audit unit helps the taxpayer obtain a license and then assesses it any appropriate taxes that need to be paid. Beyond searching for unlicensed subcontractors, however, DOR auditors do not routinely look for other possible third party relationships, such as vendors or related party associations.

The DOR's audit unit did not keep statistics, nor provide any to the Tax Discovery Unit, on the results of its routine discovery searches for subcontractors that had no business privilege licenses. It did not have data, for example, on the number and kinds of subcontractors its auditors had discovered, or the outcomes of further audit work involving the subcontractors.

Recommendation

We commend the DOR for its routine search for unlicensed subcontractors as part of the tax compliance audit function. We suggest that it consider expanding its procedures to pursue other third party relationships such as vendors or related party associations [3608.15].

We also recommend the Audit Unit begin keeping statistics on its discovery efforts and pass these statistics on to the Discovery Unit. Such information could provide useful leads to the Discovery Unit for a more targeted education and discovery program [3608.16].

"Best Practice" — Use Periodic Amnesty Programs and /or On-going Tax Disclosure Opportunities

Many tax agencies offer periodic tax amnesty programs as a way to entice taxpayers, who may have failed to file; underpaid their taxes; or have become delinquent, to pay a defined amount in exchange for forgiveness of the liability (including interest and penalties) with the added assurance of not having to face criminal prosecution. For example, the State of California's most recent amnesty program, which ended on March 31, 2005, applied to individuals and businesses. It waived all penalties if a taxpayer paid past taxes plus interest in full by March 31, 2005; or set up an installment agreement to pay taxes in full by June 30, 2006. The program was opened to anyone who had failed to file tax returns or needed to file corrected tax returns if they had understated their tax obligation. If taxpayers meeting the requirements did not participate, they risked higher penalties if discovered through California's normal tax compliance efforts.

As an alternative to tax amnesty programs, which typically are limited in time, some tax agencies offer on-going voluntary tax disclosure programs. These programs generally focus on taxpayers who clearly are subject to the tax laws and regulations of a jurisdiction, but have not filed or paid any taxes. Normally, when a voluntary disclosure occurs, a taxpayer will approach the taxing agency to register as a taxpayer and negotiate payment, in exchange for the tax agency waiving back-tax liability, civil penalties and even interest. The DOR for the City of Chicago, IL, for instance, has an on-going program that allows taxpayers to voluntarily disclose any taxes, fees, or surcharges due the city, provided the taxpayer is not under audit or investigation. In exchange Chicago agrees to waive all penalties that would otherwise apply and not assess back taxes beyond four-years (as compared to its normal statutory six-year look back).

Tax amnesty and voluntary disclosure programs have become a very effective tool for tax agencies. They provide the agencies with a low cost method of enforcement, as well as tax discovery. Most importantly, when taxpayers who have not previously filed disclose their existence, they become properly registered to pay the appropriate taxes moving forward.

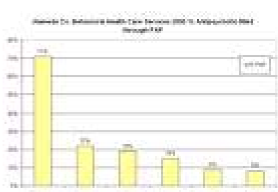
Findings

Philadelphia has periodically implemented tax amnesty programs in the past. However, the last major amnesty event occurred in 1986. It reportedly led to the collection of $20 million in delinquent taxes from 30,000 personal and business taxpayers over a three-month period. Moreover, the program purportedly brought 2,000 new taxpayers onto the rolls. Currently, the DOR has indicated it has no plans to offer another tax amnesty program.

As to a voluntary disclosure program, the DOR does have such a program that is on-going. Only taxpayers that have never filed with the department and for which the DOR has not sent notice of discovery can qualify for the program. Under the DOR's disclosure program, taxpayers can expect the DOR to seek collection of six years of back taxes along with interest. The program allows for waiver of any penalties so long as the amount does not exceed the department's authority of $10,000.[7]

<u>Recommendation</u>

We recommend that since it has been over 20 years since the last tax amnesty program, DOR study the cost effectiveness of offering such a program again [3608.17].



BEST PRACTICES FOR FOLLOW-UP AND RESULTS

"Best Practice" — Evaluate and Document Tax Discovery Results

To determine the success or failure of tax discovery efforts, leading tax agencies define specific goals for tax discovery and then measure results against the goals. Measuring results goes hand in hand with the development of a strategic plan (see page 3) in that once a strategy is developed, management needs to identify and track key measures aimed at gauging success or failure of the strategy. Tax agencies that we surveyed frequently evaluated the success of their tax discovery efforts using measures such as tax revenue collected from non-filers

[7] Amounts in excess of $10,000 require the DOR to involve the City's Law Department in any final settlement.

and the percent of voluntary compliance. Other examples of key measures used in assessing the success of tax discovery efforts include:

- ❑ Assessment sustainment rate — *% of gross assessments not abated.*
- ❑ Return filing rate — *% of non-filers contacted that subsequently file a tax return*
- ❑ Notice of assessment — *% of non-filers contacted that are subsequently issued a notice of assessment*
- ❑ Repeat non-filer rate — *Frequency of not filing in the four subsequent years*
- ❑ Cost benefit ratio — *Cost of generating revenues to revenue collected*

Findings

The DOR's evaluation of its tax discovery efforts appears very minimalistic. The department has not developed and documented a strategic plan as discussed earlier. Consequently, it has not established goals and meaningful measures of performance to assess the success or failure of its discovery efforts.

We did observe periodic internal management reports that provide a few output statistics for the relatively small number of discovery initiatives undertaken by the Tax Discovery Unit each fiscal year. Table 1 summarizes these statistics for fiscal year 2008.

Table 1: Summary statistics for fiscal year 2008 tax discovery initiatives

Dollars in millions

Tax discovery initiatives	Number of Assessments	Dollars Assessed	Dollars Collected
Self-employed residents	514	$4.1	$1.8
Residents employed outside Pennsylvania	481	1.1	.9
School Income Tax dividends	602	.6	.6

Source: Office of the City Controller from DOR data

The DOR also prepares monthly internal production reports portraying each revenue agent's assessment activity including the dollars he or she assessed and number of cases each agent handled. DOR managers could not produce reports showing any of the key measures listed on the previous page. Additionally, for the statistics shown in Table 1, the department had no further break out of the data by types of self-employed businesses being assessed, or by the types and locations of businesses failing to withhold wage tax on City residents, which they employed. Such information might be useful for better focusing discovery efforts, including identifying industries or classes of taxpayers to target with educational materials.

Recommendation

In our opinion, the reports prepared by the DOR are good, as they provide DOR management with a sense of overall staff productivity. Nonetheless, they fall short of supplying management with specific details about the characteristics of the businesses or individuals that are being assessed. Additionally, and perhaps even more importantly, the reports fail to provide managers with a sense of how operationally effective and efficient the department really is.

We recommend that DOR management consider implementing a system that, in addition to monitoring overall productivity, focuses on the results. Instead of just monitoring the dollar value of assessments, consider keeping an eye on the percentage of the assessments not abated, or the percentage of non-filers contacted that are subsequently issued a notice of assessment [3608.18].

DOR management should also think about designing tax discovery initiatives that flow out of a strategic plan and are tied to specific goals. The department should attach meaningful performance measures to each tax discovery initiative and continually evaluate the success or failure of meeting the goals [3608.19].

We reviewed the DOR's fiscal 2008 strategy for tax discovery. Our objective was to ascertain industry "best practices" and compare these against the initiatives employed by the DOR as conveyed to us by its senior management.

To ascertain the industry "best practices" for tax discovery, we contacted other state and local government operations across the nation. These included the states of California, Massachusetts, Pennsylvania, Washington, and the cities of New York, NY, Los Angeles, CA, Chicago, IL, Seattle, WA, Washington DC, and Kansas City, MO. We also reviewed procedures utilized by the IRS and private sector organizations that contract with state and local governments to perform tax discovery. We collected information by way of telephone interviews and review of practices posted to a variety of internet sites.

To determine the DOR's initiatives used for tax discovery, we interviewed: the senior-level and front-line managers of the department's Revenue Compliance Program including its Director, Revenue Examiners in charge of audits and tax discovery, the Revenue Investigation Manager heading up investigations, the Tax and Revenue Conferee Supervisor overseeing technical tax issues, Revenue Exam Supervisors for audit and two Collection Customer Rep Supervisors in the Tax Discovery Unit. We then compared these initiatives against the industry "best practices' identified from the procedures set forth in the preceding paragraph.

We based the findings discussed throughout this report solely on the above procedures. We did not observe or otherwise verify any of the actual tax discovery initiatives carried out by those individuals and/or units responsible. Our work did not include reviewing any of the technical aspects of tax discovery such as the accuracy of assessments or the adequacy of IT routines used to discover non-filers of City tax returns.

We performed our work from March through November 2008 in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the engagement to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our engagement objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our engagement objectives.

Type	Description	Rates†
Amusement Tax	Imposed on the admission fee charged for attending amusements in Philadelphia	5% of admissions
Business Privilege Tax	Required if engaged in business in Philadelphia, whether or not the business earned a profit in the preceding year.	0.1540% on gross receipts 6.5000% on net income
Hotel Room Rental Tax Rate of Tourism & Marketing Tax	Imposed on the rental of a hotel room to accommodate guess	7% on amount received for rental of rooms
Liquor Sales Tax	Imposed on sale of liquor by entities holding license or permit issued by Commonwealth of Pennsylvania	10% on every retail sale of liquor or malt and brewed beverage that is not subject to Pennsylvania Sales Use and Occupancy Tax
Net Profits Tax	Imposed on entire net profits of any business conducted in Philadelphia	4.2600% (city residents) 3.7557% (non-city residents)
Parking Tax	Levied on gross receipts from all financial transactions involving parking in Philadelphia	15% of amount charged for parking
Real Estate Tax	Imposed on all real estate in the City of Philadelphia	(*Per $1000 of taxable assessed value*) $33.05 - city $49.59 - school $82.64 - total
Real Estate Transfer Tax	Levied on the sale or transfer of real estate located in Philadelphia	3% city - 1% state - 4% total based on value of property transferred
Sales Tax	Imposed on retail sales of personal property or services, and upon use within Philadelphia	7% total on retail sale of merchandise or service (1% city and 6% state)
School Income Tax	Imposed on various classes of unearned income, not subject to Philadelphia business or wage taxes	3.98% on unearned income tax
Use & Occupancy Tax	Imposed on business, trade or commercial use and occupancy of real estate in Philadelphia	$4.62 per annum per $100 of assessed value
Vehicle Rental Tax	Levied on vehicles rented for 29 or fewer consecutive days	2% on amount received for renting a vehicle
Wage/ Earning Tax	Imposed on compensation paid to an employee, employed by or rendering services to an employer in Philadelphia	3.98% (city resident) 3.5392% (non-city resident) on gross wages

†Rates in effect for calendar year 2008
Source: prepared by the Office of the City Controller from the DOR web site and the City of Philadelphia's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2008

Best Practice	IRS	Pennsylvania	California	Washington	Massachusetts	Seattle, WA	Los Angeles, CA	New York, NY	Chicago, IL	Kansas City, MO	Washington DC	Philadelphia, PA
1. Develop a data-driven strategic plan	●		●	●								.
2. Build a data warehouse	●	●	●	●	●			◖	●		◖	
3. Use data mining technology	●	●	●	●	●		●	●	●		◖	
4. Utilize a tax clearance system		●	●		◖	◖				●	●	◖
5. Use a fraud hotline / whistleblower program	●	●	●	●	●	●	●	●	●		●	
6. Develop tax awareness through education	●	●	●	●	●	●	●	●	●	●	●	◖
7. Conduct street level observations		●	●	●	●	●	●	●	●	●	●	◖
8. Develop leads from field audits	●	●		●		●	●	●	●	●		●
9. Use periodic tax amnesty/tax disclosure program	◖	●	●	●	●	●		●	●	●	●	●
10. Evaluate tax discovery efforts	●		●	●	●							

● Practice fully implemented
◖ Practice partially implemented

Office of the Controller

City of Philadelphia

Financial and Policy Analysis Unit

The Underground Economy in Philadelphia

Executive Summary

Philadelphia's construction sector has experienced a recent boom, pushed upward by a strong housing market, tax abatements on new construction, and national recognition of Philadelphia's renaissance. With the benefits of a burgeoning economy come growing pains; in the case of Philadelphia's construction industry those growing pains come in the form of an informal construction economy that costs the city in a number of ways.

Like many other localities throughout North America, Philadelphia has recently come to the realization that much of its labor is performed by workers who are either undocumented or are misclassified by their employers. Forming a significant portion of the "informal economy", these workers typically do not pay income taxes (or they pay less than they should), while their employers skirt some costs of doing business by avoiding payment of payroll taxes and social insurance programs (such as unemployment insurance, worker's compensation, health insurance, etc).

Misclassified construction workers are prevalent throughout the country, representing about 15-25% of the overall construction workers in the places where it has been studied. Due to the nature of the work and the structure of employment, the construction industry has higher incidences of misclassification than other sectors of the economy. Research in Washington State found that construction firms were 1.4 times more likely to misclassify workers than firms in any other industry, while a similar report in New York State found that 15% of the construction workers there are misclassified compared to 10% of workers in all other sectors.

The costs of worker misclassification come in a number of forms. Direct costs to governments come from lost tax revenue and social insurance premiums. Indirect (and therefore much harder to measure) costs come from increased risk to workers, demand for city services, and costs-of-doing-business passed on to legitimate employers.

A very rough estimate of direct costs to the City of Philadelphia from lost wage taxes amounts to between $2.1 million and $7.4 million.

Policies that have been suggested in other studies fall under two categories: enforcement and regulation. On the enforcement side, suggestions include increasing efficiency and efficacy by joining state and local efforts, as well as by incorporating industry-based policing. Regulation suggestions include clarifying or changing the legal definitions of worker class and requiring a prevailing wage for all government-sponsored construction.

The Problem: Worker Misclassification

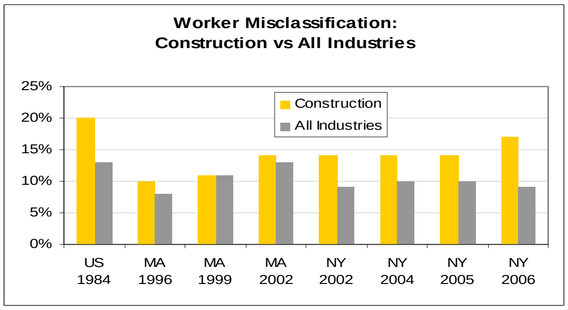
As the economy of Philadelphia has transitioned from manufacturing to service sectors, informal economies have thrived, as they have in most cities of the US. Filling the gap of services to low-income consumers, low-margin businesses compete, at least in part, by skirting regulation costs. At the opposite end of the underground economy, the rise of condo- and office-towers downtown spurred a rise in the demand for skilled labor on myriad job sites. Meanwhile, between the upper and lower floors of the local economy lie smaller job sites, employing fewer workers per job, but with far more individual jobs. If other cities are any indication, much of the work being performed on these sites is being done by misclassified and undocumented workers.

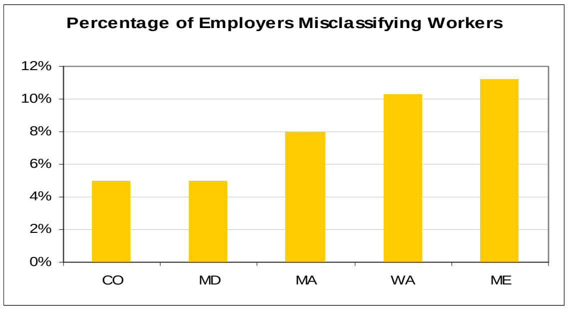
Worker misclassification is the intentional or unintentional classification by an employer of a worker as an independent contractor rather than as a salaried or waged employee. Misclassification generally happens for one of two reasons: the employer does not correctly understand the difference between the types of worker, or because the employer hopes to avoid various costs of an employee (such as payroll taxes and social insurance programs).

Employers of misclassified workers typically submit the appropriate paperwork to government agencies, allowing them to claim that they're following the law. On the subject of taxes and other required payments, employers will say that these are the responsibility of the contractor. Much less common, undocumented workers are workers who are not declared to any government agency, and therefore are not taxed at all.

The Extent of the Problem

The issue of misclassified workers in the construction industry has been studied in just a handful of places: New York City, New York State, Maine, Massachusetts, Washington State, and Ontario. Based on these reports, an average of about 15% of construction workers are either undocumented or misclassified. In New York City, which has been experiencing a construction boom over the past decade, the number jumps to about 25%. Comparing misclassification in the construction industry to other industries, the study in Washington State found that "employers in the construction industry are 1.4 times more likely to misclassify workers."[1] In New York City, for example, informal workers represent about 10% of the overall workforce, whereas in the construction industry they make up about 15% of the workforce.

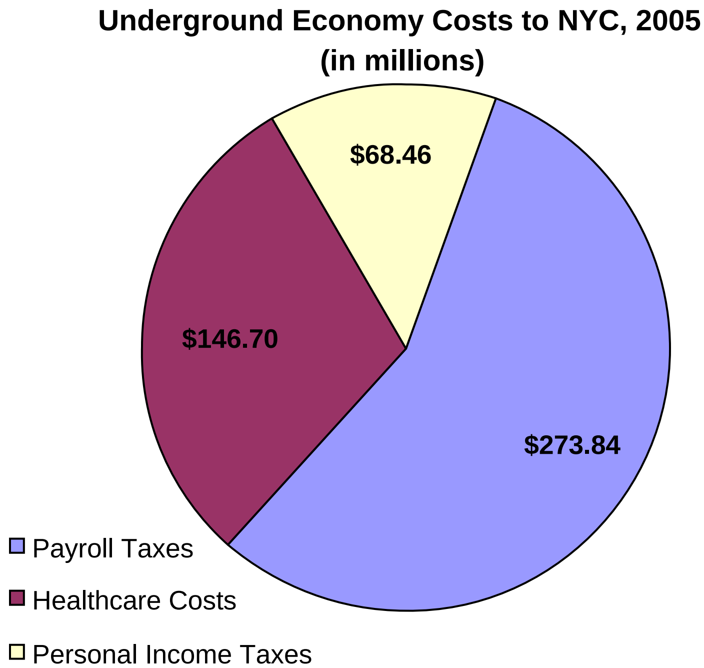




The costs associated with misclassified workers, as found in the places that have been studied, are significant. In New York City, the informal construction economy cost the city about $489M in 2005, and was expected to rise by approximately 114% over 3 years. Of this total, 56% came from payroll taxes, 30% were from increased healthcare costs, and 14% were from lost personal

[1] Findings & Recommendations Joint Legislative Task Force on the Underground Economy in the Construction Industry, 15 Feb. 2008

income taxes. While indirect costs that stem from misclassified workers are inherently difficult to quantify, there is a "strong correlation between construction fatalities and the characteristics of the underground economy."[2] Of the 51 construction fatalities that occurred in 2006 and 2007 in New York City, 75% of the employing firms were non-union, 50% were very small, and "failure to provide safety training was cited in over half of the cases."[3]



Research Scope

While the construction sector represents a minority of the overall informal economy, it is a reasonable focus of study for a number of reasons. To start, the construction industry represents the kind of "low-hanging-fruit" that makes sense to study. Construction projects, regardless of the status of the workers, are typically well documented with permits, loans and other paperwork. Construction projects are easily found on the street and do not move, whereas informal retail and other businesses typically blend into surrounding areas or are portable. Compared to other areas of the overall informal economy, the construction sector is relatively visible and immobile, and therefore easy to study.

Based on findings in other places, the construction industry is also a cohesive and significant portion of the overall informal economy. Construction firms are more likely than other types of businesses to misclassify workers, which is likely due to the nature of the work. While jobs are inherently immobile, workers leap from one job to the next, following the work throughout the city. Small residential firms, typically employing a handful of people, will hire independent contractors for days, weeks or months at a time. Meanwhile construction firms have to compete for work, with time- and cost-estimates their only real way to stand out amongst the other bidders. The two factors, of cost-sensitive employers and workers with no job security, collide to

[2] Building Up NY, Tearing Down Job Quality Fiscal Policy Institute, 5 Dec. 2007
[3] Ibid

create an atmosphere in which proper worker classification is too expensive, too slow, and too inconvenient for workers or employers to bother with.

The construction industry is unique among other industries for the scale of its impact on the city's present and future. Unlike retail and restaurants, construction firms leave a significant physical mark on the landscape of the city. Cutting corners in construction projects can present immediate dangers to the workers, to nearby businesses and residents, and to passerby. Unlike in other businesses, worker's errors also have lasting effects that may not be detected for years, and which may present serious, unseen risks to people and property.

For these reasons, the Office of the Controller has focused its study on the construction industry. The combination of relative ease of study, size of impact, and the safety implications make the informal construction industry a strong subject of study. Additionally, lessons learned during the course of compiling data for this report may be applicable to studies of other sectors of the informal economy in the future.

Research Methods

Studying informal economies is an exercise in comparative analysis. This study will require a series of audits, comparing one set of data to another to find discrepancies. Data sets to compare may include:

Growth in 1099 filings	Vs.	Growth in private payroll employment
Registered company names	Vs.	Advertisements for businesses of that type
Unemployment insurance claims	Vs.	Unemployment insurance payments
Industry estimates from BLS, ACS, etc	Vs.	Industry estimates from PA Dep. Of Labor
Declared income of workers	Vs.	Industry audits
Growth in utility usage	Vs.	Growth in economic indicators
Growth in building permits	Vs.	Growth in industry employment
IRS filings	Vs.	State/Local tax filings
Quarterly Census of Employment & Wages	Vs.	Current Population Survey employment data
US. Bureau of Economic Analysis regional accounts data	Vs.	Similar county data

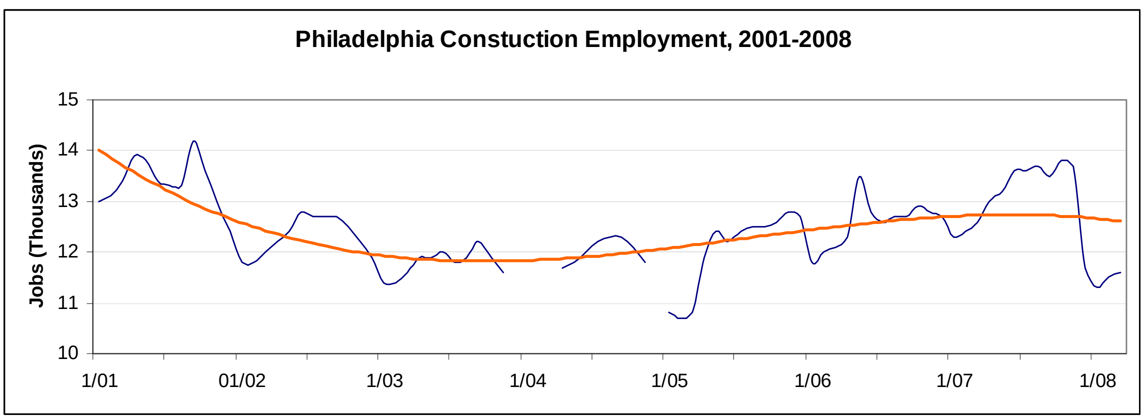
Following the collection of the data, analysts will estimate the direct costs of the informal construction economy, using procedures outlined in similar studies. A simple, albeit imprecise method of estimating costs to government of informal workers is to multiply the estimated number of misclassified workers by the estimated average per-worker cost to the government (which is arrived at by comparing revenue from employees to revenue from independent contractors). Similarly, applying the city's wage tax rate to an income estimate for the number of misclassified/undocumented workers will give a rough idea of their cost to the city. While the estimates provided by these methods will not be precise, they will provide an idea of the costs that the City of Philadelphia is incurring due to informal employment in the construction sector.

An example of a more complicated and exact measure is found in the New York City study, where researchers devised a five-step method of estimating costs in which workers were grouped by wage and compliance status. For each group, per-worker estimates of payroll and social insurance premiums led to industry-wide estimates of lost taxes and insurance premiums for the non-compliant groups, followed by estimates of lost income taxes and of the costs that are shifted to other entities. Numbers provided by this method will be somewhat more precise than those of the simpler methods.

Concurrent to the collection of the economic data, researchers have explored policies in other cities and states to identify a set of best practice recommendations. Most of the research that has been done on this subject has been performed at the state level, so most of the existing policy recommendations involve state law rather than local ordinances. Given this, the policy recommendations will involve, at least in part, a call for increased state/local communication and cooperation and lobbying the state for classification standards.

Findings

Based on existing research of the informal construction economies of other places, this office expects that the local informal construction economy will represent approximately 15-25% of the overall construction sector. In New York City, the bulk of the underground construction economy is found in residential construction, where most of the construction businesses are small, with only 4-10 full-time employees compared to 15-25 for non-residential construction companies. Approximately 66% of the affordable housing sector in NYC is underground (which represents about 20% of the entire underground construction economy). While Philadelphia is obviously much smaller than New York, this office expects to find proportionate similarities in our construction industries. New York, like Philadelphia, has enjoyed a construction boom since 2000, with the "biggest surge in residential construction activity since the 1970s." Additionally, both New York and Philadelphia's real estate markets and their construction economies have remained fairly strong relative to the nation.



Prior to performing the audits, this office ran up a very rough estimate of the local informal construction economy. Comparing numbers from the US Bureau of Economic Analysis, the Census Bureau and the Bureau of Labor Statistics, we estimated that the Philadelphia construction economy represents between 11,000 to 20,000 jobs. Based on proportions from other reports, a very rough estimate of the number of misclassified workers in Philadelphia gives a range of 1,650 to 5,000 workers. Multiplying these numbers by the median wage from the Census Bureau (about $35,000), and again by the wage tax rates, and the very rough estimate of lost income taxes is between $2.1M and $7.4M. While this rough estimate is exactly that, it does give us an idea of the expected breadth and depth of the informal construction economy in Philadelphia.

Recommendations

"Government has an obligation to curb the underground economy, enforce long-standing employment laws, ensure compliance with essential social insurance protections and eliminate the unfair competitive advantage from contractors in the underground economy"

In the existing body of policy papers on this subject, the most common recommendation is to ensure that all agencies use the same criteria to determine the appropriate classification for workers. Following this, most of the policy recommendations include a call to presume worker classification as employees, putting the onus on the employer to prove that the worker is an independent contractor. In a number of states, bills have been passed that presume employment status or require that the employer prove the independent status of a worker.

On the municipal level, policy recommendations are to work with the state to increase enforcement, to require prevailing-wage labor on all government-sponsored projects, and to ensure that enforcement efforts are even-handed and fair, taking into account "an often vulnerable workforce that includes many black and Hispanic workers long shut out of opportunities for good-paying jobs, skill development and advancement, or who are recent immigrants."

By far the most effective way for local government to reduce the scale of the underground construction economy is through projects that, in any form, receive assistance from local government. Whether through funding (in part or in whole), zoning variances, or tax incentives, Philadelphia offers various types of assistance to developers. By the nature of the construction industry, responsibility for the many functions of development is handed down through a number of of firms. Holding all involved contractors of city-assisted projects to a prevailing-wage standard will go a long way towards reducing the effect of the informal construction economy in Philadelphia. In an FPI report studying misclassified workers in New York City's affordable housing construction, the authors call for municipalities to "take responsibility for the working conditions" by working with the state to "begin enforcing labor standards and addressing working conditions and the poor pay and benefit practices"[4] that exist in government-assisted construction.

Beyond increasing enforcement of existing laws, Philadelphia should work with surrounding municipalities and the state to update these laws. In a number of states, laws have been enacted that presume worker employee status; in Massachusetts, for example, employers must prove that workers meet three criteria to be determined independent. In some states, there are bills that amend the definition of independent contractor so that various state agencies (for example the unemployment and workers' compensation bureaus in Maine) will use one definition. Increased civil and criminal penalties are also parts of a number of states' reactions to the informal construction economy. Pennsylvania's most recent attempt (2005-06 HB 1215) to deal with the informal construction economy did not pass the House. Philadelphia and surrounding municipalities should work together to lobby for increased enforcement, a clear and consistent definition for "independent contractor", and stiff penalties for employers who knowingly misclassify workers.

[4] The Underground Economy in the New York City Affordable Housing Construction Industry Fiscal Policy Institute, 17 Apr. 2007

CITY OF PHILADELPHIA

KEITH J. RICHARDSON, M.B.A.
REVENUE COMMISSIONER

May 18, 2009

The Honorable Alan Butkovitz
City Controller
1230 Municipal Services Building
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102-1679

Re: Department of Revenue (DOR) Tax Discovery Program

Dear Mr. Butkovitz:

Thank you for the opportunity to discuss the contents of your draft report at the exit conference held on April 16, 2009. The following are the Revenue Department's responses to the recommendations in the report.

Revenue Department Can Improve Its Program For Tax Discovery By Adopting Some Best Practices

We agree with the recommendation by the City Controller that the Revenue Department can improve its program for tax discovery by adopting some "best practices" of other taxing jurisdictions. To that purpose, Department of Revenue managers currently meet on a regular basis with IRS staff members and the employees of revenue departments from other cities to discuss their practices in tax discovery. The information obtained in this way is reviewed for feasibility and implemented when applicable. As discussed with members of your staff at the exit conference, many of the recommendations in your report had been implemented, or in were in development at the time of the City Controller review.

"Best Practice" – Develop a Data Driven Strategic Plan

The Department of Revenue utilizes a strategic tax discovery plan. This plan is based on the leading edge use of the data analysis and tax gap analysis of the IRS referenced in your report. The Department of Revenue has reviewed the IRS tax gap analysis where it has relevance to the applicable Philadelphia taxes such as the City Wage Tax, Business Privilege Tax, Net Profit Tax and School Income Tax. Discovery projects are identified and implemented based on an analysis and use of the information provided to the Department of Revenue through its information sharing agreement with the IRS. *It may be worth noting that none of the municipalities contacted by the City Controller has a data strategic plan in place.*

"Best Practice" – Build a Data Warehouse Useful for Performing More Varied and Meaningful Analyses

We agree that a data warehouse would enable us to perform data analysis more effectively. Our internal programming resources have not been sufficient to undertake a project of such scope. We have met and will continue to meet with non-governmental providers to determine the costs and requirements of constructing a data warehouse. Previous cost estimates were approximately $5 million.

"Best Practice" – Use Data Mining Technology to Identify Tax Evaders

We agree that the use of data mining technology is an effective tool to identify tax evaders. The use of STAX (State Tax Automated Compliance System Software) has resulted in the identification of thousands of tax evaders resulting in millions of dollars of additional tax revenue. In addition to utilizing STAX, we regularly scan local newspapers and telephone directories as well as other internal and external sources to identify tax evaders.

"Best Practice" – Utilize a "Tax Clearance" System to Encourage Payment of Outstanding Tax Liabilities

We agree with your recommendation and are in the process of expanding our "tax clearance" system.

"Best Practice" – Use a Fraud Hotline/Whistleblower Program

The DOR implemented a tax fraud hotline on May 11, 2009. The hotline enables citizens to call the Department of Revenue to report tax fraud at 215-686-3852. In addition a special address, City of Philadelphia, Revenue Department, P.O. Box 1680, Philadelphia, PA 19105-1680 and web address, **taxfraud@phila.gov**, have been dedicated to enable citizens to report tax fraud by mail or email.

"Best Practice" – Encouraging Voluntary Compliance through Education

We agree that an effective taxpayer education program stimulates voluntary compliance. To that end, the DOR has held seminars for citizens as well as tax professionals, distributed brochures, and utilized cable television and the internet to educate citizens about Philadelphia taxes. In May of 2008, the DOR created the new position of Director of Policy, Planning and Outreach. Since the appointment, our Director has involved the DOR in additional community outreach efforts, created additional print media, improved the content of the DOR web page and created ReveNews, a quarterly electronic news letter.

"Best Practice" – Conduct "Street Level Observations"

We agree that routine and targeted "street level observations" can be an effective tool for closing the tax gap when used with other tax discovery "best practices." In May of 2008, Revenue Investigators were reassigned to field duty. This field assignment included "street level observations" that were conducted through the use of City vehicles and have generated tax assessments in excess of one million dollars.

"Best Practice" – Develop Leads for Non-filers As Part of Tax Compliance Audit Function

As noted in your report, as part of their taxpayer audits the DOR Revenue Examiners routinely collect information to identify subcontractors who may not be licensed to do business in Philadelphia. We are currently considering your suggestion to expand the procedures to pursue other third party relationships such as vendors or related party associations and to maintain statistics on our findings.

"Best Practice" – Use Periodic Amnesty Programs and/or Ongoing Tax Disclosure Opportunities

As noted in your report the DOR currently has a Voluntary Disclosure Program. This program is effective in bringing many taxpayers into compliance and generating additional tax revenue each year. The overall effectiveness of tax amnesty programs in improving tax compliance is a matter of some discussion. The DOR last held a tax amnesty in 1986.

"Best Practice" – Evaluate and Document Tax Discovery Results

The DOR Tax Discovery Unit currently maintains detailed reports that are subject to strict confidentiality requirements and therefore intended for internal use by authorized supervisors and managers. The reports provide detailed information regarding the efficiency and effectiveness of tax discovery projects and the Tax Discovery Unit.

Thank you for the observations provided in your report and the opportunity to respond.

Sincerely,

Keith J. Richardson
Revenue Commissioner

Cc: Rob Dubow, Director of Finance
Steve Agostini, Budget Director
Frank Breslin, Deputy Commissioner
Joseph McTamney, Compliance Operations Manager