TAX MANAGEMENT ASSOCIATES, INC.

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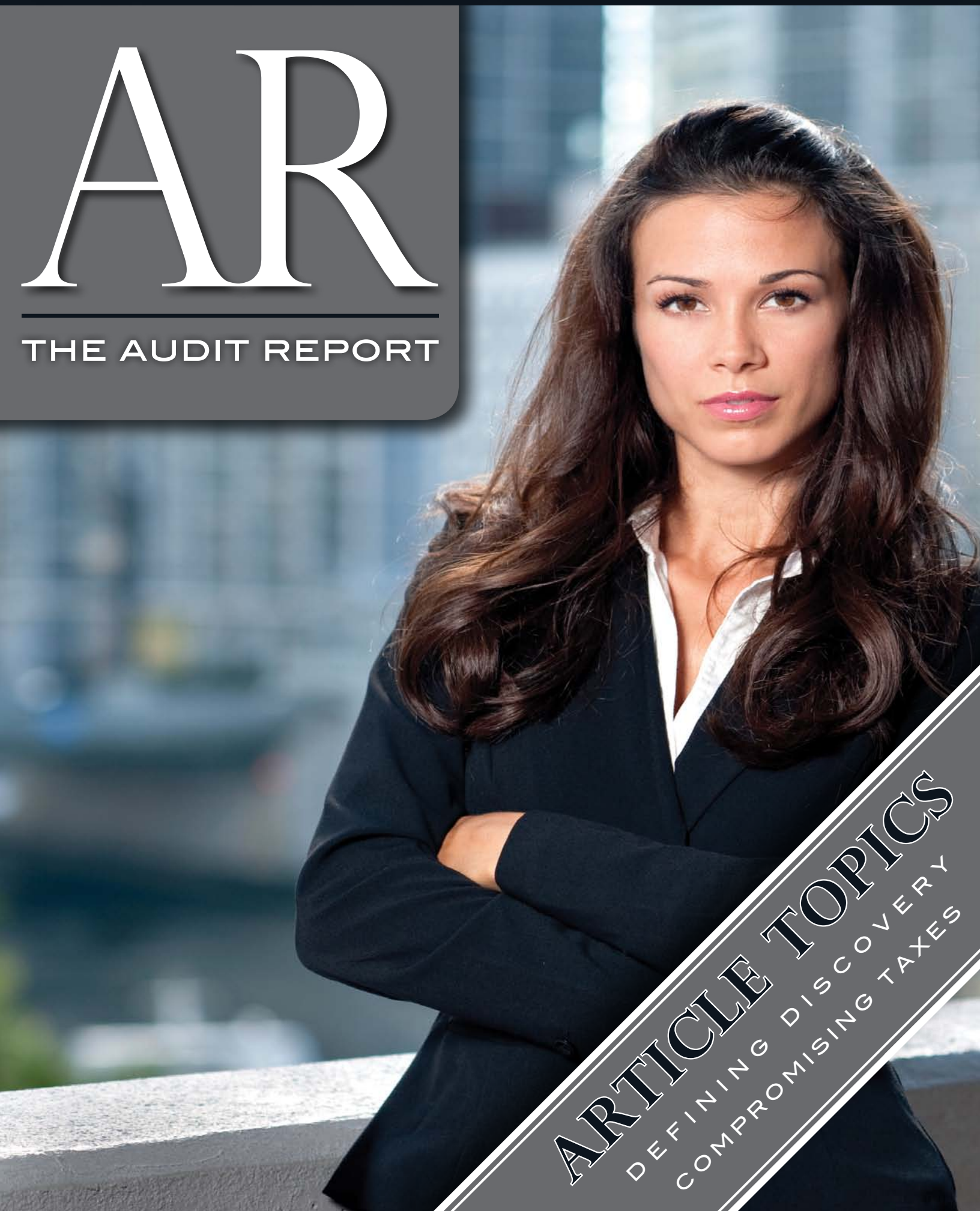
THE AUDIT REPORT



ARTICLE TOPICS

DEFINING DISCOVERY

COMPROMISING TAXES

Defining Discovery

What Constitutes as a Discovery in Tax Administration? | *By Sarah Diehl*

There are a lot of definitions out there for what constitutes as a discovery in tax administration. The meaning varies from state to state and county to county. Not all jurisdictions actually use the term discovery. For example, the Code of Alabama § 40-7-23 refers to an assessment on a discovery, or failure to file as "escaped taxes." According to the International Association of Assessing Officers (IAAO), "discovery" is the process whereby the assessor identifies all taxable property in the jurisdiction and ensures it is included on the assessment roll.

Here in North Carolina, N.C. Gen. Stat § 105-312 (6a) defines a discovery as: property that was not listed, property that was listed but included a substantial understatement, or property that has been granted an exemption and does not qualify for an exemption. Given these variances, tax professionals must be careful to correspond clearly amongst ourselves and taxpayers across all jurisdictions. This is just one reason why TMA strives for continual communication with our clients on the services we offer.

The TMA Discovery Program takes the approach defined by the IAAO

"The TMA Discovery Program includes all correspondences with taxpayers to inform, verify, and collect business personal property returns on all discovered businesses."

to identify taxable business personal property. When breaking down this definition, one might question what "all taxable property" truly means. For TMA, our program focuses on the use of technology to run an extensive search through various resources to obtain the most comprehensive list of businesses operating within any given jurisdiction. Once that list of businesses moves through our internal process, we are able to give an inclusive catalog of the companies not reporting to the tax office. Typically, this list is between 10-12% of the current tax roll, often increasing discovered value by millions of dollars in just one year.

Many times jurisdictions are eager to start a discovery program but do not have the resources to handle the additional workload that comes with finding so many taxable accounts. Who will process the returns or handle the increase in phone volume once additional accounts are discovered? This is where TMA thrives in creating additional value for our clients. The TMA Discovery Program includes all correspondences with taxpayers to inform, verify, and collect business personal property returns on all discovered businesses. Our call center with over 30 full time professionals

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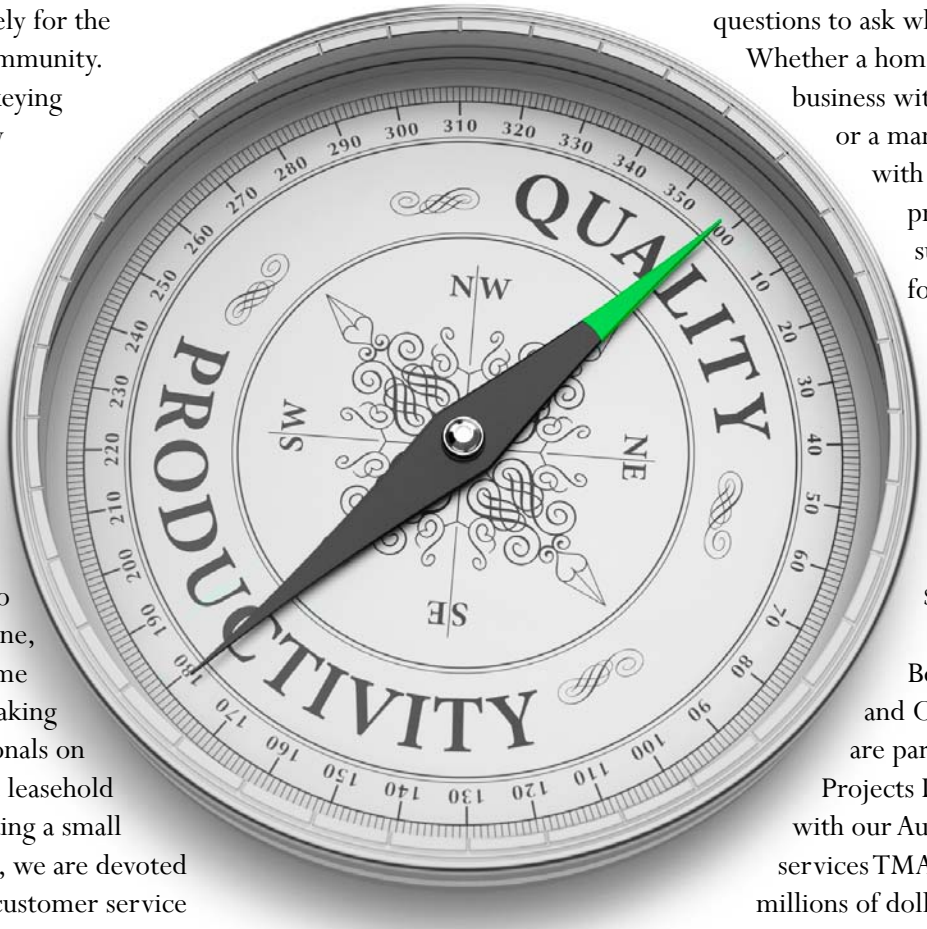
is available Monday through Friday to assist both taxpayers and tax offices with any questions or concerns about the discovery process.

Parallel to the Discovery Program is the TMA Outsourcing Program. This service line focuses on personal property listing administration. Dedicated to processing returns timely and accurately, our team of professionals ensures that returns are assessed appropriately for the benefit of the entire community. Our staff is capable of keying listings directly into any jurisdiction's revenue management system or processing returns in-house and exporting the information back to the tax office. We also provide services whereby we act as the personal property call center for jurisdictions; handling all calls and walk-in traffic related to assessing business, marine, aircraft, and mobile home accounts. Whether speaking with other tax professionals on what truly constitutes a leasehold improvement or educating a small business on what to file, we are devoted to providing excellent customer service to the tax office and the public.

Perhaps the best way to explain that TMA has the most comprehensive picture of what a discovery truly means is by looking at our current projects. For one of our clients in Georgia, we provide an Outsourcing, Discovery, and Audit Program throughout the year. During the listing process our staff members key returns and answer all questions directed to the tax office. By reviewing each return for supporting documentation and undocumented additions or deletions, our staff ensures that this jurisdiction is not picking up any value that is not rightfully owed. We work so closely with the tax office that we are able to call attention to any accounts that are grossly undervalued, or accounts that should be analyzed because they are out of business or exempt.



A great example to illustrate this point was a taxpayer who owned a recycling facility. This taxpayer had claimed and received an exemption for over 100 recycling containers at their facility. Upon reviewing the documentation of the business, we found they had 500 additional containers that they had not filed an exemption for as they were purchased and therefore were over reporting their business personal property value. It was our duty to inform the taxpayer of this oversight to ensure uniform assessment was given to all.

As our staff is extremely familiar with this jurisdiction's tax roll, when we started the Discovery Program it allowed us to spend time finding the accounts that would really add value to the tax base. We knew what type of businesses to look for and the right questions to ask when we found them. Whether a home based construction business with $200,000 in assets, or a manufacturing company with $1 million, this program has been so successful that we have found over $65 million in discovered value to date. This number even excludes the discovered value we have found from our Audit Program, which totals over $139 million.

Both the Discovery and Outsourcing Programs are part of the TMA Special Projects Division. Together with our Audit Division's services TMA is capable of finding millions of dollars in discovered value every year. Our broad range of services allows any jurisdiction to run the most comprehensive discovery program in the market today. No matter how a jurisdiction defines a discovery, if a tax office is looking for a way to increase revenue and decrease costs, TMA can provide a solution.

Compromising Taxes

Is it Constitutional to Compromise Taxes on Discovered Property? | *by Kirk Boone*

In North Carolina, if the all-time list of property tax experts were limited to five names, there are one or two names that no other expert would leave off. One of those names is Bill Campbell. His list of contributions to North Carolina property tax could easily be a published work in itself, however the purpose of this article is to highlight one of his many published works from the Spring 1989 edition of *Popular Government*, a periodical from the Institute of Government at the University of North Carolina at Chapel Hill. TMA is honored to have permission to reprint this work in the *The Audit Report*.

My personal opinion has long been that counties should not compromise taxes on discoveries. Doing so rewards scofflaws and penalizes the honest taxpayer by forcing them to pay more than their fair share. It is simply not fair to the average taxpayer, the hard working citizen that pays the taxes owed on their house and car, without possibility of compromise. If those responsible for listing have the knowledge that a governing body might compromise the tax or penalty if they get caught, it only encourages the attempt to leave things off the list. Imagine an income tax system if we all knew that under reporting our income could result in less tax than if we reported accurately, even if we got caught – that's nonsense! I don't want to add or take away anything from what you are about to read, but I do want to point out some of the highlights you don't want your governing body to miss:

> *"…counties should not compromise taxes on discoveries. Doing so rewards scofflaws and penalizes the honest taxpayer by forcing them to pay more than their fair share"*

1. The power to compromise the tax described herein is only available AFTER the value and the amount of the tax have been established. It does not grant the board or anyone else the authority to change the established value. Pursuant to NC G.S. 105-312(d), the tentative appraisal and listing described in the discovery notice become final absent an appeal within 30 days.

2. It is the author's opinion that, even if a board attempts to establish rules and standards in order to equitably and fairly compromise taxes on discovered property, doing so is unconstitutional, because under the board's terms the board is not required to proceed on the basis of generally applicable standards. This is especially

If you have any questions or comments about this article, please contact Kirk Boone at 1-800-951-5350

applicable for boards that have policies, for example, that release half of the discovery penalties, or forgive penalties if it is the taxpayer's first discovery.

3. From the article: "It is difficult to explain why - in a rational tax scheme - a property owner who voluntarily lists property for taxes on time must pay the full amount due, but a property owner who fails to list may have the taxes compromised by the governing board."

"Compromising Taxes on Discovered Property: An Unconstitutional Statute?" Reprinted from Popular Government with permission from the Institute of Government. All rights reserved.

The North Carolina property tax law sets out an elaborate procedure for listing and assessing property that was not listed during the regular listing period (usually the month of January).[1] Property listed under G.S. 105-312 is categorized as "discovered" property. After the county assessor has listed and appraised the property and the property owner has exhausted any appeals to the discovery that he or she wishes to pursue, taxes on the property are computed and a late-listing penalty is added to the taxes. The penalty is 10 percent for each year's listing period that the property was not listed. Thus, if property is discovered for one year, the penalty is 10 percent, if it is discovered for two years; the penalty is 20 percent, and so on. The maximum period for which property can be discovered is the current year plus the preceding five years.

After the assessor computes the total amount, prepares the tax receipt, and charges it to the tax collector, the taxpayer may petition the governing board of the taxing unit to "compromise" the tax. This compromise authority allows the board to release any portion of the total tax bill that is legally due. The statute that authorizes this compromise, G.S. 105-312(k) reads as follows:

(k) Power to Compromise. – After a tax receipt computed and prepared as required by subsections (g) and (h) of this section has been delivered and charged to the tax collector as prescribed in subsection (j), above, the board of county commissioners, [Subsection (I) extends this authority to municipal governing boards] upon the petition of the taxpayer, may compromise, settle, or adjust the county's claim for taxes arising therefrom. The board of commissioners may, by resolution, delegate the authority granted by this subsection to the board of equalization and review, including any board created by resolution pursuant to G.S. 105322(a) and any special board established by local act.

Three aspects of this statute are significant in considering its possible constitutional deficiencies. First, the power granted to the governing board is not authority to settle a disputed claim for the tax: at this stage of the proceedings the value of the property and the amount of the tax have been established and are not in dispute. Second, the governing board is authorized to compromise the principal amount of the taxes; it is not restricted to a compromise of the late-listing penalty. And third, there are no standards - absolutely none -to guide the governing board in exercising this compromise authority. In the absence of standards, a governing board is free under the statute to treat petitions from three different taxpayers, each owing $10,000 in taxes and penalties on discovered property, in three entirely disparate ways. The board could refuse to make any compromise in the first case, compromise only the penalty in the second case, and compromise the tax and penalties to $1.00 in the third case, based on whatever the board finds to be good policy.

The governing board's compromise authority in the case of discovered property has been in the property tax law for a respectably long time. It first appeared in the Machinery Act of 1935, [2] was carried over unchanged in the Machinery Act of 1939, [3] and was continued with no substantive changes in the Machinery Act of 1971. During this fifty-four year history, only one reported case has considered the application of the statute, and that case did not challenge its constitutionality.[4] But this untroubled history will not preserve the statute if an appropriate challenge is brought. A taxpayer denied a compromise of a tax claim when other taxpayers have received compromises would be sufficiently affected by the board's action (that is, "have standing") to challenge the statute's constitutionality, as would a taxpayer who received less of a compromise than another taxpayer in similar circumstances.

Consider, for example, the case of two taxpayers who fail to list their motor vehicles. The county assessor discovers the vehicles and adds the 10 percent late-listing penalty plus the special $100 penalty for motor vehicles.[5] Then both taxpayers petition the board of commissioners for a compromise of

the tax claims. One of the taxpayers owns an automobile, and the other owns a boat trailer. The board decides to compromise the $100 penalty on the trailer and to deny any compromise to the automobile owner. Nothing in G.S. 105-312(k) prevents the board from making that sort of distinction. The owner of the automobile would have standing to challenge the constitutionality of G.S. 105-312(k). Suppose the owner does file suit challenging the statute, what are his or her chances of success? In my opinion, they are good. (Editor's Note: At the time this article was written, North Carolina law required motor vehicles to be listed, and allowed the assessor to impose a $100 penalty for failure to do so).

By granting to city and county governing boards standardless authority to compromise tax claims on discovered property, the legislature has empowered those governing boards to exercise arbitrary discretion that may deprive taxpayers of property without due process of law, and such a statute is contrary to Article 1, Section 19 of the North Carolina Constitution (law of the land clause). Two cases are especially compelling on this point. The first is Bowie v. Town of West Jefferson[6] in which a local act authorized the town to appraise property for ad valorem taxation at a level different from the appraisal made by the county. The act contained no standards for establishing the appraised value of property in the town and no requirements for notifying property owners of their tentative values and giving them a right of appeal. The court held the act unconstitutional under the Fourteenth Amendment of the United States Constitution and the law of the land clause of the North Carolina Constitution. The court found the act constitutionally deficient both because of lack of standards to guide the municipality in appraising property and because of the absence of notice requirements. The town board had, in fact, given property owners notice of their values. But the court said that this would not save the statute; its constitutionality must be measured by what the board could do under the statute, not what it did. The lesson of this part of the decision for present purposes is that even if a local governing board attempted to adopt rules establishing the conditions under which compromises would be granted under G.S. 105-312(k) this would not save the statute, because under its terms the board is not required to proceed on the basis of generally applicable standards.

In the second case, In re Application of Ellis[7] Guilford County adopted a resolution to the effect that (1) in administering its zoning ordinance, applications for special exception permits would be decided by the board of county commissioners and (2) the board could take into account "the public interest" in granting or denying a permit. The North Carolina Supreme Court held that the board's denial of an application pursuant to this resolution denied property owners due process of law. The court summarized the constitutional infirmity in these words: "[T]he commissioners cannot deny applicants a permit in their unguided discretion …. [T]hey must . . . proceed under standards, rules, and regulations, uniformly applicable to all who apply for permits."[8]

This zoning case is relevant to the statute under consideration for two reasons. First, the court found the county's procedure to be unconstitutional because it was not in conformity with the requirements of due process of law, not because it was a delegation of legislative authority without sufficient standards. The court has held that the prohibition against standardless delegation of legislative authority, derived from Article II, Section I of the North Carolina Constitution, does not apply when the General Assembly delegates broad authority to local governments to legislate regarding local matters." The court left this principle undisturbed in Ellis; it did not base its decision on the ground that the General Assembly unconstitutionally granted local governments authority to adopt special exceptions to zoning regulations. Instead, the court stated that in exercising this delegated authority, local governments are bound by the same constitutional limitations that would bind the General Assembly if it chose to exercise its zoning authority directly: "Power to zone rests originally in the General Assembly, but this power is subject to the constitutional limitation forbidding arbitrary and unduly discriminatory interference with the right of property owners."[10] Thus, although the case involved the exercise of a delegated power by a local government, the court, in effect, held that for purposes of constitutional analysis the county resolution should be treated as though it were a state statute.

Second, the case is important because it rebuts the argument that G.S. 105-

312(k) is constitutional because no taxpayer has a right to a compromise, that every taxpayer has a duty to pay the amount of taxes and penalties due, and that no taxpayer can successfully argue that he or she is somehow treated unfairly because the board exercises its discretion not to grant a compromise. No property owner has a "right" under a zoning ordinance to a special exception permit, either, but Ellis requires that the power to grant or deny permits not be exercised arbitrarily. In the same way, the power to compromise a tax claim must not be exercised arbitrarily, as G.S. 105-312(k) permits.

If I am correct and G.S. 105-312(k) is indeed an unconstitutional provision, how can it be amended to correct the deficiency? One possibility is simply to repeal G.S. 105-312(k) and to place taxes on discovered property on the same footing as all other taxes. If they are legally due, they must be paid in full.[11] A good case can be made for repeal, if only because it is difficult to explain why - in a rational tax scheme - a property owner who voluntarily lists property for taxes on time must pay the full amount due, but a property owner who fails to list may have the taxes compromised by the governing board.

Short of repeal, a second possibility would be to follow the model of G.S. 105-237, which gives the secretary of revenue authority to reduce or waive any penalties on state taxes, provided the secretary makes a written record of the reasons for the waiver or reduction. This authority would still be without standards to guide the governing board, but perhaps it could withstand constitutional challenge because it extends only to the penalty. However, it could be argued that a statute that allows arbitrary release of penalties suffers from the same constitutional infirmities as one that allows an arbitrary compromise of the tax claim.

The third possibility would be to follow the model of G.S. 105-237.I, which gives the secretary of revenue, with the concurrence of the attorney general, authority to compromise state tax claims in four limited circumstances. Two of those circumstances are relevant to taxes on discovered property: (1) the taxpayer is insolvent, and the taxing unit could not collect an amount greater than that offered as settlement; and (2) collection of a greater amount than that offered in compromise is improbable, and the funds offered in the settlement come from a source from which the taxing unit could not otherwise collect. Placing these, or other similar conditions, on the governing board's power to compromise would provide standards for the exercise of its discretion and would eliminate the unconstitutional arbitrariness that now exists in the statute.

1. N.C. Gen. Stat. § 105-312. Hereinafter the General Statutes will be cited as G.S.

2. 1935 N.C. Code § 7971(50)5.

3. Former G.S. 105-33I(d).

4. The case is Stone v. Board of Commissioners, 210 N.C. 226, 186 S.E. 342 (1936). The Stoneville town board compromised a tax claim on discovered property for $100, and residents of the town brought suit seeking a writ of mandamus to force the board to collect the full amount of the tax claim. The court denied the application for mandamus upon finding no evidence that the board had acted in bad faith or had abused its discretion.

5. G.S. 105-312(h1).

6. 231 N.C. 408, 57 S.E.2d 369 (1950).

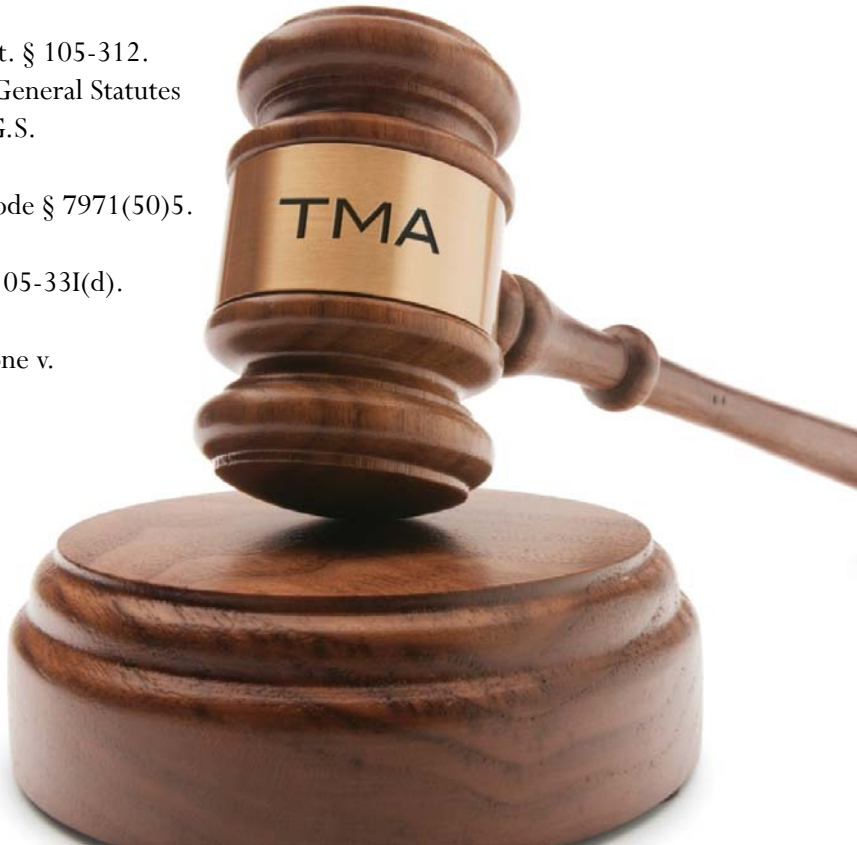
7. 277 N.C. 419. 178 S.E.2d 77 (1970)

8. 277 N.C. at 425. 178 S.E.2d at 81.

9. See, eg., Jackson v. Guilford County Bd. of Adjustment, 275 N.C. 155, 166 S.E.2d 78 (1969).

10. 277 N.C. at 425. 178 S.E.2d at 80.

11. See G.S. 105-380 and 105-381.



Tennessee Government Day	Nashville, TN	April 19-20
South Carolina Association of Assessing Officers	North Myrtle Beach, SC	May 2-6
Connecticut Association of Assessing Officers Annual Spring Meeting	Southington, CT	May 12
Northeastern Regional Association of Assessing Officers Annual Conference	Uncasville, CT	May 15-19
Alabama County Administrators Conference, Orange Beach	Perdido Beach Resort, AL	May 18-19
Government Finance Officers Association Annual Conference	San Antonio, TX	May 22-25
Indiana County Auditors Association	Vevay, IN	May 25-27
Connecticut Association of Assessing Officers School	Storrs, CT	June 5-10
North Carolina City/County Managers Association Summer Conference	Sea Trail, NC	June 23-25
Michigan Association of Equalization Directors	Traverse City, MI	July 10-13
North Carolina Finance Officers Association Summer Conference	Wrightsville Beach, NC	July 17-19
Georgia Association of Assessing Officers Summer Conference	Jekyll Island, GA	July 17-20
Alabama Tax Administrators Conference	Orange Beach, AL	July 23-28
South Carolina Association of Assessing Officials	Hilton Head Island, SC	July 29-Aug 2
Wichita Utility Conference	Wichita, KS	July 31-Aug 4

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