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SUMMARY OF: A special report on the Department of Revenue (DOR), Seafood Industry Tax and Assessment Revenues, May 19, 2011

PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit on the DOR Tax Division's completeness and accuracy of seafood related tax collections. Furthermore, we evaluated the Tax Division's reconciliation of reported taxed values and volumes to state and federal reports of harvest as well as the Tax Division's audit process.

REPORT CONCLUSIONS

DOR's fisheries tax audits are too limited in scope to provide assurance that tax revenues are complete and accurate. Currently, fisheries-related tax audits are limited to Salmon Product Development (SPD) tax credits. There are no formal or established procedures in place for assessing risks in order to determine where to focus audit resources for fisheries tax programs or selecting taxpayers for audit. Additionally, there are no documented policies or procedures for auditing fisheries tax revenues other than those relating to the SPD tax credit.

Regulatory changes are needed to support DOR's accurate and complete collection of fishery taxes. Specifically, regulations for enforcing the SPD tax credit have not yet been adopted.

The Commercial Operator's Annual Reports can be a valuable tool in ensuring accurate tax payments for Fisheries Business Taxes. On a limited basis, reconciling reported taxed volumes or corresponding values of seafood harvest can be performed to verify components of the Fisheries Business Taxes. This could be an effective tool for identifying high risk taxpayers needing additional evaluations and potential audits.

Alternative price reporting information is not available to DOR for comparative purposes. DOR is not permitted to access confidential federal resource managers' harvest reports. Federal laws governing programs administered by National Oceanic and Atmospheric Administration, National Marine Fisheries Service prohibits sharing confidential harvest data with outside agencies unless the data is specifically needed for resource management. With the exception of one city, fish taxes collected by local municipalities are not comparable as a tax base to the Fisheries Business Tax. Therefore, local community tax data is not an effective source of outside information for the State to verify reported taxed values and volumes. Furthermore, the data contained in the Alaska Salmon Price Report is not useful to the Tax Division in their mission to collect taxes. This is because the report collects information on wholesale and retail values of processed fish rather than unprocessed values which is the basis for state seafood taxes.

Taxpayer audits are necessary to verify that all year-end price adjustments or other bonuses paid to fishermen have been properly reported. Although it is possible to identify all bonus returns filed in a given year, this method would only capture bonuses paid after the original return is filed, thereby producing an incomplete record of actual bonuses paid. Furthermore, this method would not identify taxpayers who paid year-end bonuses, but did not report them to DOR.

FINDINGS AND RECOMMENDATIONS

1. DOR's commissioner should diversify audits of fisheries-related tax revenues based on a risk assessment.

2. DOR's commissioner should adopt regulations to enforce the Salmon Product Development tax credit.

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July 11, 2011

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF REVENUE
SEAFOOD INDUSTRY TAX AND
ASSESSMENT REVENUES

May 19, 2011

Audit Control Number
04-30061-11

The overall objective of the audit is a performance evaluation of the Department of Revenue, Tax Division's completeness and accuracy in collecting seafood-related taxes. Furthermore, we evaluated the Tax Division's reconciliation of reported taxed values and volumes to state and federal reports of harvest as well as the Tax Division's audit process.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

Pat Davidson

Pat Davidson, CPA
Legislative Auditor

TABLE OF CONTENTS

OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Alaska Department of Revenue (DOR), Tax Division collection of seafood industry taxes and assessments. The audit was designed to determine the extent to which the Tax Division reconciles reported taxed values (pricing) and volumes against state and federal reports of harvest. The audit also evaluated the effectiveness of the Tax Division's audit process over seafood related taxes and assessments. The objectives, scope and methodology of our review are as follows.

Objectives

The specific audit objectives were to:

1. Determine if the Tax Division:

    a. Reconciles reported taxed volumes or the corresponding values of seafood against state and federal resource managers' reports of harvest and against the Commercial Operators Annual Report (COAR).

    b. Has access to adequate price reporting to verify declared taxed values is consistent with real market conditions, and, if so, determine if the Tax Division reconciles the amounts reported to those outside sources.

2. Determine if revenues collected include any and all year-end price adjustments or other bonuses paid to fishermen.

3. Determine if the Tax Division adequately audits taxpayers to ensure the appropriate amount of taxes are paid.

4. Determine if statutory or regulatory changes are needed to support the Tax Division's accurate and complete collection of fishery taxes.

Scope

The audit covered the five-year period of July 1, 2005, through June 30, 2010, and included six seafood-related tax and assessment programs administered by the Tax Division. More specifically, we examined and analyzed the following programs: Fisheries Business Tax, Fisheries Resource Landing Tax, Seafood Marketing Assessment, Salmon Enhancement Tax, Seafood Development Tax, and Dive Fishery Assessment. For calendar-year tax returns, the five-year period was from December 31, 2005, through December 31, 2009. At the time of this audit, 2009 was the most recent year for which complete data was available.

Methodology

We interviewed Tax Division staff. The purpose of the interviews was to (1) obtain information pertaining to tax reporting requirements, processing tax returns, and collecting revenue; (2) determine whether fisheries tax information reported to DOR is reconciled against or compared to data collected by outside agencies; and (3) obtain an understanding of audit risk assessment procedures, audit selection methodologies, and amounts collected through audit activities.

We interviewed the Department of Fish and Game's (DFG), commercial fisheries division staff. The purpose of the interviews was to obtain information regarding fish tickets, COAR reports, and any other data collected pertaining to weight and/or value of fish processed.

We interviewed the Alaska Seafood Marketing Institute (ASMI) staff to gather information about the ASMI assessment that is currently levied on all licensees who process seafood worth more than $50,000 in a year. We also inquired about sources of fisheries data that ASMI uses for budget projections.

We interviewed a representative of the National Oceanic and Atmospheric Administration, National Marine Fisheries Service (NMFS). The purpose of the interview was to obtain information about what data is reported to NMFS, how it is collected, and with whom it may be shared.

We obtained background information on the tax and assessment programs, and researched the statutes and regulations applying to each.

We obtained downloads from databases maintained by DOR (tax return data) and DFG (COAR report data). We attempted to reconcile unprocessed weights and values in the two databases. The purpose of this reconciliation was to determine whether the COAR reports could be used as an outside data source to corroborate weights and values reported to DOR on fisheries business and/or landing tax returns.

We evaluated the current DOR policies and procedures pertaining to fisheries tax audits. This was accomplished by interviewing management and staff as well as obtaining and analyzing documentation of completed fisheries-related audits. We also examined records of amounts collected as a result of audit assessments. Additionally, we analyzed documentation supporting assessment reversals that occurred as a result of the appeals process.

ORGANIZATION AND FUNCTION

The Department of Revenue (DOR) is responsible for the administration, enforcement, and collection of state tax, royalty, and assessment revenue. Additionally, it is DOR's responsibility to ensure proper custody and investment of funds received by the State. DOR provides administrative support to a number of boards, corporations, and authorities. To carry out these responsibilities, DOR employs over 850 personnel and has an operating budget of more than $250 million.

The Tax Division is one of five divisions within DOR. The Tax Division is responsible for the administration of over twenty separate tax, assessment, and fee programs – six, of which, are related to the State's seafood industry. Additionally, the Tax Division is responsible for regulating charitable gaming and distributing shared taxes and fees. The Tax Division is organized according to functional groups – one, of which, is the Fisheries Tax Examination and Audit.

The Fisheries Tax Examination and Audit group is currently comprised of seven full-time positions: one manager, one tax auditor, and five tax technicians. The fisheries tax audit position has been in place since FY 04 and was initially authorized when the Salmon Product Development (SPD) credit[1] was approved by the legislature through HB 90 (Ch 57, SLA 2003). The group is responsible for examining and auditing all fisheries-related tax returns and licensing respective taxpayers.

[1]The SPD is a tax credit against the Fisheries Business Tax to encourage the development of salmon products and the utilization of salmon waste.

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BACKGROUND INFORMATION

The Department of Revenue (DOR), Tax Division oversees the administration, enforcement, and collection of various state taxes. In FY 10, DOR reported total revenue collections of $4.3 billion dollars, of which $59.6 million, or just over one percent, was from fisheries-related taxes, fees and assessments.

There are six types of fisheries-related taxes and assessments. Exhibit 1 shows the total revenue collected from FY 06 through FY 10 by type of tax or assessment.

Exhibit 1

FY 06 through FY 10
Revenue Collections by Tax Type

Tax Type	FY 06	FY 07	FY 08	FY 09	FY 10	Total	Total %
Fisheries Business Tax	$ 32,839,797	$ 35,038,254	$ 34,905,903	$ 42,130,897	$ 31,895,515	**$ 176,810,366**	**58%**
Fisheries Resource Landing Tax	11,496,766	11,165,580	14,287,967	9,551,751	12,948,568	**59,450,632**	**19%**
Seafood Marketing Assessment	6,110,573	6,928,167	8,053,608	9,016,211	7,770,049	**37,878,608**	**12%**
Salmon Enhancement Tax	4,369,091	4,351,313	5,493,912	5,833,257	4,882,558	**24,930,131**	**8%**
Seafood Development Tax	152,465	1,266,303	1,370,170	1,399,317	1,581,114	**5,769,369**	**2%**
Dive Fishery Assessment	246	426,006	373,120	391,183	523,024	**1,713,579**	**1%**
TOTAL	**$ 54,968,938**	**$59,175,623**	**$ 64,484,680**	**$ 68,322,616**	**$ 59,600,828**	**$ 306,552,685**	**100%**

Fisheries Business Tax

The Fisheries Business Tax is levied on persons who process or export fisheries resources from Alaska. The tax is based on the price paid to commercial fishermen for the unprocessed fishery resource, or fair market value when there is not an arms-length transaction. The

Fisheries Business Tax is primarily collected from licensed processors and persons who export fish from Alaska.

Fisheries Business Tax rates are based on the location, type of processing activity, and whether a fishery resource is classified as "*established*" or "*developing*."[2]

Fisheries businesses are required to file calendar-year tax returns and pay the resulting taxes by March 31st of the following year. After filing the calendar-year return, taxpayers must also file returns reporting post-season bonus payments made to fishermen. Bonus payment returns and additional taxes are due by the last day of the month immediately after the bonus payment.

Fishery Resource Landing Tax (Landing Tax)

The landing tax is levied on any processed fisheries resource that is subject to the American Fisheries Act (AFA), Sec. 210(f)[3] or on fisheries resources processed outside the three-mile limit[4] and first landed in Alaska. The tax is based on the unprocessed value of the resource which is determined by multiplying a statewide average price[5] by the unprocessed weight. The landing tax is primarily collected from factory trawlers and floating processors which process fishery resources outside of the State's three-mile limit.

Landing tax rates are based on whether the resource is classified as "*established*" or "*developing*."

Taxpayers are required to file returns and pay taxes on a calendar-year basis by March 31st of the following year. However, if the Tax Division does not provide statewide average prices for fishery resources before the March 31st due date, taxpayers are automatically given filing extensions. In such instances, the return filing date is extended until the last day of the month after DOR publishes the statewide average price listing. Taxpayers are required to estimate and pay quarterly taxes which are due on the last day of each calendar quarter.

Seafood Marketing Assessment

The Seafood Marketing Assessment is levied on seafood processors and fishermen who export fishery resources out of Alaska. The Seafood Marketing Assessment is 0.5 percent of the unprocessed value of seafood products processed, or first landed in and exported from

[2]The Department of Fish and Game determines which fishery resources are classified as "*established*" or "*developing*." Developing resources are taxed at a lower rate.
[3]Per AFA, Sec. 210(f), the landing tax is also applied to pollock caught in the Alaska fishery but not landed in the State.
[4]The exclusive economic zone extends from three miles to 200 miles offshore; it is commonly referred to as the "*three-mile zone*."
[5]The statewide average price list is developed using the data reported in the Fisheries Business Tax returns and the Commercial Operators Annual Report submitted to the DFG, both of which are annually due March 31st of the following year.

Alaska. Processors and fishermen who produce less than $50,000 of seafood products during a calendar year are exempt from the assessment.

Taxpayers are required to file calendar-year returns and pay taxes before April 1st of the following year. Taxpayers must also file monthly returns for post-season bonus payments made to fishermen after the filing of the calendar-year return. Returns for these payments and additional assessments are due by the last day of the month following the bonus payments. The Tax Division deposits all Seafood Marketing Assessments into the State's General Fund. The legislature may appropriate funds to the Alaska Seafood Marketing Institute.

Salmon Enhancement Tax

The Salmon Enhancement Tax is levied on salmon sold in or exported from established aquaculture regions in Alaska. This tax is levied on fishermen who pay the tax to licensed buyers at the time of sale. Buyers remit taxes collected from fishermen to DOR. Fishermen who sell salmon to unlicensed buyers or who export from Alaska must pay the tax directly to DOR.

The tax is based on the price paid to the fishermen for the unprocessed salmon and varies depending on the location of the aquaculture association. The southern and northern regions of Southeast Alaska are assessed at three percent; the Cook Inlet, Prince William Sound (PWS), Kodiak, and Chignik regions are assessed at two percent.

Seafood Development Tax

The Seafood Development Tax is levied on salmon harvested by set gillnet fishermen in PWS as well as drift gillnet fishermen in both Bristol Bay and PWS. The one percent tax is collected from fishermen by licensed buyers at the time of sale and is based on the price paid for the unprocessed salmon. Fishermen who sell to unlicensed buyers or who export from Alaska must pay the tax directly to DOR.

Dive Fishery Management Assessment

The Dive Fishery Management Assessment is levied on geoducks, sea urchins, and sea cucumbers harvested in the southeast dive region. It is an elective assessment on the value of fisheries resources taken using dive gear. The assessment only applies to designated management areas and species, and is assessed at a rate elected by a vote of permit holders.

The assessment is collected by licensed buyers from dive fishermen at the time of sale and is based on the price paid for the resource. Dive fishermen that sell to unlicensed buyers in or export from Alaska must pay the tax directly to DOR.

Buyers are required to file returns and remit taxes quarterly. The due date is the last day of the month following the calendar-year quarter of purchase. Buyers must file returns for bonus payments made to fishermen after the close of the fishing season. Returns for these payments and additional taxes are due by the last day of the month following the bonus payment.

Salmon Product Development (SPD) Tax Credit

Applicable to the Fisheries Business Tax, the SPD tax credit allows taxpayers to claim credits for expenditures promoting the development of salmon products. The credit was originally enacted in 2003 for a three-year period. The legislature has subsequently extended the sunset date three times. Currently, the credit is in effect until December 31, 2015.[6] The amount of the credit is limited to 50 percent of the tax liability incurred from processing salmon. An unused credit may be carried forward for a three-year period.[7]

The SPD credit may be claimed for a *qualified investment* in new equipment intended for processing salmon in the State of Alaska. In order to meet the *qualified investment* criterion, expenditures must be for an item of depreciable property with a service life of at least three years. The purpose of this item must be to produce value-added salmon products beyond heading and gutting. Equipment for which the SPD credit is claimed must perform one or more of the following functions: filleting, skinning, portioning, mincing, forming, extruding, stuffing, injecting, mixing, marinating, preserving, drying, smoking, brining, packaging, blast freezing, or pin bone removal.[8] Equipment that is claimed for an SPD credit must be used within the State of Alaska for a minimum of three years. As shown in Exhibit 2, if the equipment is disposed of or removed from service in Alaska less than three years after purchase, all or part of the amount claimed as a credit is subject to recapture.[9]

Exhibit 2

SPD Tax Credit
Recapture Schedule

Years After Purchase	Credit % Subject to Recapture
< 1	100
1-2	75
2-3	50
>3	0

Licensing, Tax Return, and Payment Processing

Under AS 43.75.011, a person engaging or attempting to engage in a fisheries business or in an activity described in AS 43.75.100 shall first apply for and obtain a license. Licensing of fisheries businesses provides a means for the Tax Division to identify all taxpayers. Fisheries businesses must obtain a license from DOR and an Intent to Operate (IO) permit from the Department of Fish and Game (DFG) annually.

Application processing is a joint effort between DOR and DFG. All applications are submitted directly to DOR's Tax Division through their online licensing system. DOR is

[6]Senate Bill 164-Ch 3, SLA 06; HB 321-Ch 8, SLA 08; HB 344-Ch 102, SLA 10
[7]Alaska Statute 43.75.035(d)
[8]Alaska Statute 43.75.035(j)(3)
[9]Alaska Statute 43.75.035(g)

responsible for reviewing, approving, and issuing fisheries business licenses. DFG reviews, approves, and issues the IO permits after DOR issues the fisheries business license. Any entity or person applying for a DFG IO permit must go through DOR's online licensing system.

The Tax Division utilizes two separate databases, the data entry and examination system and the tax accounting system (TAS), to process returns and payments. All fisheries tax returns are examined by tax technicians. The examination is mainly a verification of mathematical accuracy and timeliness. The group also verifies that all licensed taxpayers submitted the required tax forms each year. If tax returns are not filed as required by statute, DOR is authorized to file a return for the taxpayer, using the best information available to the agency at the time. In such cases, DOR contacts DFG for fish tickets or Commercial Operators Annual Reports (COAR) in order to estimate weight and value data. (See below for an explanation of these items.) Using this information, DOR estimates the taxes due and issues a demand for payment including penalties and interest.

If a processor owns multiple facilities, a separate fisheries business license number is issued for each plant, cannery, or vessel. For the Fisheries Business Tax, a separate return must be filed for each license. For the landing tax, the taxpayer may compile data from all vessels onto one return.

<u>Fisheries Resource Data Collected by DFG</u>

Fish tickets are a critical component of the State's oversight of the commercial fishing industry. Alaska requires that all commercial fish operators document fish landings using a fish ticket. The fish ticket lists the catch by species, area caught, and gear used. The fish ticket is the key document for establishing a paper trail for landed fish. The fish ticket's purpose is to manage resources rather than to enforce tax compliance; therefore, pricing information is not required.

DFG requires all licensed processors to file an annual COAR. This report lists all fish purchased and/or processed by a licensee. There are two main types of COAR forms: buying and production. The former is to report seafood purchased from fishermen; the latter is to report fish processed by the licensee. A licensee may report on both forms or on one depending on their business activity.

Numerous data elements are required by COAR; however, some key data elements include:

- Species;
- Weight (*unprocessed* on buying forms, *processed* on production forms); and
- Value (*unprocessed* on buying forms, *processed* on production forms).

A separate COAR is required for each license held. For example, if a shore-based processor had multiple plants, a separate COAR would be required for each location. Likewise, if a licensee owns several processing vessels, a separate COAR must be submitted for each vessel. DOR compiles the statewide average price lists based on COAR data and data maintained in DOR's TAS database.

Alaska Statute 16.05.815(a)(3) allows DOR access to confidential fishery-related data maintained by DFG. The data includes fishery harvests for each licensed/permitted operator through DFG's fish ticket system, eLandings, and COAR.

The Alaska State Troopers (AST) Role in Fisheries Resource Management

The AST's Wildlife Enforcement Division focuses on enforcing fish and wildlife laws, not tax laws. While AST may verify that an operator is properly licensed, they do not check for compliance with fish tax reporting requirements. When state troopers discover an entity operating without a license, they notify DFG. Depending on the circumstances, DFG may in turn inform DOR.

Fisheries Resource Data Collected by Federal Agencies

The National Oceanic and Atmospheric Administration, National Marine Fisheries Service (NMFS) collects detailed fisheries harvest data for ground fish, halibut, and other fish harvested in the exclusive economic zone (EEZ) which extends from three miles to 200 miles offshore. The NMFS, as part of a joint effort with the International Pacific Halibut Commission and DFG, maintains an online reporting system called the Interagency Electronic Reporting System (IERS), better known as eLandings. This system creates a consolidated source for landing, production, and individual fishing quota reporting. The eLandings system provides data on the specific fisheries both in state waters and in the EEZ.[10] When fish are landed, information from fish tickets must be entered into this database. Data in eLandings can be traced back to individual vessels.

IERS reporting is concerned primarily with resource management and tracking fish mortality, rather than the amount or price of fish sold or processed.

[10]Fisheries tracked by eLandings include all rationalized crab, individual fishing quota sablefish and halibut as well as all ground fish harvest.

REPORT CONCLUSIONS

Department of Revenue (DOR) fisheries tax audits are too limited in scope to provide assurance that tax revenues are complete and accurate.

Tax Division personnel performed thorough, well-documented audits for the Salmon Product Development (SPD) tax credit. However, only SPD tax credits are being audited. The SPD tax credits represent approximately six percent of the fisheries tax revenues from FY 06 through FY 10. Consequently, DOR's audit function does not provide assurance over total fisheries tax revenues.

Furthermore, there are no formal or established procedures in place for assessing risk in order to determine where to focus audit resources for fisheries tax and assessment programs or selecting taxpayers for audit. Additionally, there are no documented policies or procedures for auditing fisheries tax revenues other than those relating to the SPD tax credit. Diversifying the audit process based on a risk assessment and documenting standard audit procedures would enhance the Tax Division's ability to ensure taxpayers are paying the appropriate amount of taxes. (See Recommendation No. 1.)

Regulatory changes are needed to support DOR's accurate and complete collection of fishery taxes.

During the five-year period from FY 06 through FY 10, taxpayers claimed just over $19 million in SPD tax credits against their Fisheries Business Tax liabilities. All of which were audited by the Tax Division. The Tax Division's audit efforts resulted in 95 assessments totaling $4,805,730. Of the 95 assessments, 24 (or 25 percent) were reversed in the appeals process. (See Exhibit 3.)

Exhibit 3

FY 06 through FY 10
SPD Tax Credit Audit Assessments

Description	Assessment #	Total %	Amount	Total % Amount
Total Assessments	95	100	$ 4,805,730	100
Reversed in Appeals	24	25	$ 1,089,104	23
In Appeals Awaiting Decision	3	3	$ 149,267	3
Paid or in Active Collection	68	72	$ 3,567,359	74

Amounts reversed in the appeals process were primarily the result of ambiguity in Alaska Statutes and a lack of finalized regulations rather than deficiencies in the audit work. To strengthen the Tax Division's collection of fisheries taxes, DOR should finalize and adopt regulations for enforcement of the SPD tax credit. (See Recommendation No. 2.)

<u>The Commercial Operators Annual Report (COAR) can be a valuable audit tool to ensure accurate tax payments for Fisheries Business Taxes</u>.

Auditing of fisheries taxes and assessments is limited to SPD tax credits. DOR's Tax Division does not reconcile reported taxed volumes or corresponding values of seafood against state resource managers' reports of harvest.

In order to determine if a full reconciliation was viable, we conducted a comparison of COAR data with Fisheries Business Tax and landing tax data (these two tax types represent 77 percent of total fisheries revenue). We determined a comprehensive reconciliation is not practical. However, the COAR report can be used to verify Fisheries Business Taxes for certain types of taxpayers and, thereby, provide some level of assurance.

The COAR report is not effective for reconciling landing taxes because the COAR production forms list only *processed* weight and value, while the landing tax return lists actual or estimated *unprocessed* weight and value. Moreover, the landing tax return gives taxpayers several options for estimating *unprocessed* weight and, thereby, makes reconciliation between the COAR and DOR tax return difficult if not impossible.

Overall, a reconciliation of reported taxed volumes or corresponding values of seafood harvest can be performed on a limited basis to verify components of Fisheries Business Taxes. DOR should consider using the reconciliation as a basis for assessing risk of taxpayer misreporting. This could be an effective tool in identifying taxpayers with a higher risk in need of additional evaluation and potential audit. (See Recommendation No. 1.)

<u>No alternative price reporting information is available to DOR for audit purposes</u>.

There is no alternative price reporting information that could be utilized by DOR to assess the accuracy or reasonableness of prices reported on tax returns. Potential alternative price reporting information reviewed for the audit included federal resource managers' reports of harvest, fish taxes assessed at the local level and the Alaska Salmon Price Report data.

- *Federal Resource Managers Reports of Harvest*: DOR is not permitted access to confidential federal resource managers' reports of harvest. The Magnuson-Stevens Act, governing programs administered by National Oceanic and Atmospheric Administration, National Marine Fisheries Service (NMFS), prohibits sharing of confidential harvest data with outside agencies unless the data is needed for the specific purpose of resource management. The NMFS has a memorandum of agreement (MOA) with the Department of Fish and Game (DFG) and the Commercial Fisheries Entry Commission (CFEC) to share confidential information for the specific purpose of resource management. Under the MOA, DFG and CFEC are bound by the Magnuson-Stevens Act confidentiality requirements and are prohibited from sharing any of the confidential information with agencies outside of those specifically identified in the MOA. Therefore, DOR is prohibited from gaining access to the federal harvest data.

- *Local Fish Tax Assessments*: There are twenty-seven cities within four organized boroughs and three cities in unorganized boroughs that collect fish taxes. Fish taxes collected by local municipalities, with the exception of one city,[11] are not comparable in tax base to the Fisheries Business Tax. This is primarily because the local municipality taxes are based on sales volume rather than processing activity. Since the fish taxes collected by local municipalities do not have a comparable tax base with the state Fisheries Business Tax, local community tax data is not an effective source of outside information for the State to verify reported taxed values (pricing) and volumes.

- *Alaska Salmon Price Report Data (ASPR):* The data contained in the ASPR is not useful to the Tax Division in their mission to collect taxes. This is because the report collects information on wholesale and retail values of *processed* fish rather than *unprocessed* values, which is the basis for state seafood taxes.

<u>Taxpayer audits are necessary to verify all year-end price adjustments or other bonuses paid to fishermen have been properly reported</u>.

There is no reliable method for DOR to independently verify that all amounts for year-end bonuses have been reported. Taxpayers are required to report price adjustments or other bonuses paid to fishermen. If a bonus is paid to a fisherman before the Fisheries Business Tax return is due (March 31st of the year following harvest), the bonus amount is included in the original return and is not specifically identified. The processor is required to file a separate bonus return if the bonus was paid to the fisherman after the original tax return was filed.

An audit of individual processors would be required to detect those who understate or do not report bonuses paid to fishermen. Although it is possible to identify all bonus returns filed in a given year, this method would only capture bonuses paid after the original return was filed, thereby producing an incomplete record of actual bonuses paid. Furthermore, this method would not identify taxpayers who paid year-end bonuses, but did not report them to DOR. The process is further complicated by the fact that some of the bonuses are paid as "*in-kind*" items, such as ice or fuel, rather than cash.

[11]The City of Chignik collects a fish processing tax that utilizes the same tax base as the State's Fisheries Business Tax. The percentage of revenue shares distributed to Chignik are immaterial in comparison to revenue shares to municipalities as a whole. Thus, the data collected by the City of Chignik would not be a significant source of fisheries information for the State to verify reported taxed values.

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FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The Department of Revenue (DOR) commissioner should diversify audits of fisheries-related tax revenues based on a risk assessment.

DOR's Tax Division does not have formal or documented procedures for identifying and assessing risk of taxpayer non-compliance for fisheries-related tax and assessment programs. Additionally, the Tax Division does not have written programs or procedures for conducting audits of fisheries-related tax programs other than the Salmon Product Development (SPD) tax credit.

Currently, the Tax Division has only one auditor devoted to fisheries taxes. As noted in Recommendation No. 2, the fisheries-related audit effort is devoted entirely to SPD tax credits. Due to these limitations, the Tax Division has not developed risk assessments or audit procedures and programs for conducting audits of other fisheries tax programs.

Title 43 of the Alaska Statutes authorizes DOR to collect tax revenues for the State of Alaska and ascertain the correctness of such revenue. Moreover, AS 43.05.040 authorizes DOR to examine the books, papers, records, or memoranda of any person to ascertain the correctness of a return filed or to determine whether a tax is due, or in an investigation or inspection in connection with tax matters.

Insufficient procedures over audits of fisheries-related tax revenue may result in loss of revenue including revenue subject to sharing with local municipalities and other state agencies.

DOR's commissioner should direct Tax Division management to diversify audits of fisheries tax revenues. Specifically, audit risks should be assessed and documented to aid in selecting taxpayers to be audited. Furthermore, audit procedures and programs should be developed and documented for fisheries tax programs. DOR should also consider using the Commercial Operators Annual Report (COAR) data as a tool for verifying portions of Fisheries Business Tax and assessing risk of taxpayer misreporting.

Recommendation No. 2

DOR's commissioner should adopt regulations to enforce the SPD tax credit.

DOR's Tax Division has not finalized regulations for the SPD tax credit. The SPD tax credit, enacted in 2003, allows taxpayers to claim a credit against their Fisheries Business Tax owed to the State. The credit is limited to 50 percent of the tax due. During the five-year period of review, FY 06 through FY 10, taxpayers claimed $19 million in SPD tax credits.

The SPD tax credit was originally scheduled to sunset on December 31, 2005; however, subsequent legislation extended the credit which is now slated to sunset December 31, 2015. Initially, Tax Division management did not actively pursue finalizing regulations due to the expected short duration of the credit. Subsequent to the SPD tax credit extension, changes in statutes for oil and gas taxes administered by the Tax Division have taken priority over finalizing regulations for the SPD credit.

Due to ambiguity in Alaska Statutes and the lack of clarifying regulations, DOR's fish tax unit focuses all of their audit effort on the SPD tax credit. The intensive effort in this area leaves no resources for audit activities in other fisheries tax programs. Additionally, lack of regulations compromise Tax Division audits of SPD tax credits, which is an ineffective use of audit and appeals resources. During the five-year review period, 25 percent of SPD tax credit audit assessments were reversed in the appeals process primarily due to the lack of regulations.

Alaska Statute 43.05.080 of the states, *"The department shall adopt and publish regulations necessary for the enforcement of the tax, license, or excise tax laws administered by it."*

We recommend DOR's commissioner finalize and adopt regulations governing the SPD tax credit to maximize the effectiveness of the SPD audits.

State of Alaska
Department of Revenue

Commissioner Bryan Butcher

ANGDA ~ Tax ~ Treasury ~ ARMB ~ AMBBA ~ APFC ~ PFD ~ AHFC ~ CSSD ~ AMHTA

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August 10, 2011

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LEGISLATIVE AUDIT

Dear Ms. Davidson:

Thank you for your agency's review of the Department of Revenue, Tax Division's Fisheries Taxes program. We appreciate the opportunity to respond to the recommendations contained in the preliminary audit report attached to your letter dated July 19, 2011. The deficiencies identified in your letter are itemized and addressed below:

<u>Recommendation No. 1</u>
<u>The Department of Revenue (DOR) commissioner should diversify audits of fisheries-related tax revenues based on a risk assessment.</u>

Response: We agree. The division agrees that the fisheries business tax program would be more effective if the division diversified its audits and documented procedures to identify and assess risk of taxpayer non-compliance. We also agree that we should have written procedures for conducting these types of audits. However, as the audit report states, DOR only has one auditor devoted to fisheries taxes. As such, diversifying the audits and developing procedures to identify and assess audit risk can only be achieved by reallocating resources from other programs or suspending all audits conducted by the fish tax auditor during the period of time that diversification and documentation is performed. The reallocation of our limited audit staff to fisheries tax would require sacrificing audit coverage in other tax types, such as production and corporate income tax, which we believe pose a higher audit risk. Suspending fish tax audits to develop and document new audit procedures is the better option, but even this option presents risks to the fish tax program as a whole. DOR will consider ways to achieve this objective without harming the overall fish tax program or other programs which it administers.

Recommendation No. 2
DOR's commissioner should adopt regulations for enforcement of the SPD tax credit.

Response: We agree. The division is currently in the process of drafting regulations for administration of the SPD tax credits. As noted in the legislative audit report, this credit was initially adopted by the legislature in 2003 and was scheduled to sunset on December 31, 2005. This credit has been extended three times and is currently set to expire in 2015. The initial limited period of the credit minimized the need for regulations. However, with the repeated extension of the credit, it is apparent there is a need for regulations in this area. In addition, the department has identified a need for clarification of other provisions in the fisheries tax statutes and is currently working on combined fisheries and SPD credit regulations as a single project. We expect to have regulations adopted by December 31, 2011.

We believe that we have addressed the findings and recommendations presented in the preliminary audit report, however we would welcome any additional comments or questions from you or your staff.

Sincerely,

Bryan Butcher
Commissioner

Cc: Bruce Tangeman, Deputy Commissioner, Tax Division, DOR
Jerry Burnett, Deputy Commissioner, Treasury Division, DOR
Johanna Bales, Acting Director, Tax Division, DOR