

STATE OF LOUISIANA LEGISLATIVE AUDITOR

Department of Revenue
State of Louisiana
Financial Related Audit
Baton Rouge, Louisiana

May 4, 1998



Financial and Compliance Audit Division

Daniel G. Kyle, Ph.D., CPA, CFE
Legislative Auditor

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LEGISLATIVE AUDITOR

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**DEPARTMENT OF REVENUE
STATE OF LOUISIANA
FINANCIAL RELATED AUDIT**
Baton Rouge, Louisiana

Financial Related Audit
Dated May 4, 1993

Under the provisions of state law, this report is a public document. A copy of this report has been submitted to the Governor, to the Attorney General, and to other public officials as required by state law. A copy of this report has been made available for public inspection at the Baton Rouge office of the Legislative Auditor.

May 4, 1993

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Baton Rouge, Louisiana

Financial Related Audit
Dated May 4, 1998

CONTENTS

	Page No.
Independent Auditor's Report	2
Background Information:	
Objectives	4
Audit Scope	4
Methodology	4
Finding and Recommendation	6
Attachment 1 ----- Management's Response	



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LEGISLATIVE AUDITOR

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May 4, 1998

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Baton Rouge, Louisiana

We performed a financial related audit of certain transactions of the Department of Revenue (Department). The objectives of our audit were to (1) review transactions related to selected departmental tax records, including departmental audit working papers; (2) determine the propriety of an agreement made between the Department and a taxpayer to forego audits of certain tax periods; and (3) report on our findings.

Our audit was performed in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, applicable to a financial related audit. Our audit procedures, which are described in more detail in the methodology section of this report, consisted of (1) obtaining an understanding of management controls; (2) reviewing certain Department audit files and tax records upon which the agreement noted previously was made; (3) interviewing certain Department employees; (4) reviewing Louisiana law; (5) making inquiries to the extent we considered necessary to achieve our objectives; and (6) assessing the likelihood of fraud and illegal acts in relation to the agreement noted previously.

These limited procedures are substantially less in scope than an audit of the financial statements in accordance with government auditing standards, the purpose of which is to provide assurance on the Department's presented financial statements, assess the Department's internal control structure, and assess the Department's compliance with laws and regulations that could materially impact its financial statements. Had we performed such an audit or had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Based on the application of the procedures referred to previously, the accompanying finding and recommendation represent the conditions that we feel warrant attention by the appropriate parties. Management's response to the finding and recommendation presented in this report is included in Attachment 1.

LEGISLATIVE AUDITOR

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Financial Related Acct, May 4, 1999

This report is for the use of management of the Department of Revenue and should only be used by those who fully understand the limited purpose of the procedures performed. By state law, this report is a public document, and it has been distributed to appropriate public officials.

Respectfully submitted,



Daniel G. Kyle, CPA, CFE
Legislative Auditor

DLH PH-1, 08

(2004-03)

LEGISLATIVE AUDITOR

DEPARTMENT OF REVENUE STATE OF LOUISIANA Baton Rouge, Louisiana

BACKGROUND

The Office of the Legislative Auditor received allegations concerning the administrative adjustment of taxes owed by a Louisiana taxpayer following an audit of the taxpayer's records by the Department of Revenue (Department). The adjustment resulted in a substantial reduction of taxes. In addition, concern was expressed regarding an agreement signed by the Interim Secretary of the Department and the taxpayer. This agreement, in effect, surrendered the Department's right to audit five years of the taxpayer's tax returns.

OBJECTIVES

The objectives of our audit were to (1) review transactions related to selected departmental tax records, including departmental audit working papers; (2) determine the propriety of an agreement made between the Department and the taxpayer to forego audits of certain tax periods; and (3) report on our findings.

AUDIT SCOPE

Our audit was performed in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, applicable to a financial related audit. The audit covered a review of the audit working papers prepared by the Department during an audit of the taxpayer's records for tax years 1985 through 1990. In addition, we reviewed information indicating an administrative reduction of a significant tax deficiency supported by the work of Department auditors. We also reviewed the agreement signed by the Interim Secretary that gave up the Department's right to audit the taxpayer's tax returns for the tax years 1987 through 1995.

METHODOLOGY

Our audit was performed in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, applicable to a financial related audit (general Standard and the fieldwork and reporting standards for financial related audits). Our procedures consisted of the following:

1. Obtaining an understanding of management controls and the tax audit process
2. Reviewing the Department's audit files and tax records upon which the agreement noted previously was made

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Background (Concluded)

3. Interviewing current and former employees of the Department
4. Reviewing Louisiana laws concerning the duties and responsibilities of the Department and its employees to audit, assess, and collect taxes
5. Making inquiries to the extent we considered necessary to achieve our objectives
6. Assessing the likelihood of fraud and illegal acts in relation to the agreement noted previously

LEGISLATIVE AUDITOR

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Baton Rouge, Louisiana

FINDING AND RECOMMENDATION

**Interim Secretary of the Department of
Revenue Surrendered the Department's
Right to Audit a Taxpayer**

An Interim Secretary of the Department of Revenue (Department) may have exceeded his authority when he signed an Agreement of Settlement of Tax Liability (the agreement) with a taxpayer that surrendered the Department's right to audit the taxpayer and its subsidiaries for the taxable years 1991 through 1995. In addition, the Interim Secretary used a method to calculate interest and overhead expense that had never been used for any other taxpayer in Louisiana. By surrendering the Department's right to audit the taxpayer for the taxable years 1991 through 1995 and using a new method of calculating interest and overhead expense, the Interim Secretary may have used inconsistent practices and afforded treatment to this taxpayer that other Louisiana taxpayers have not received.

On November 15, 1991, the taxpayer filed its Louisiana Corporation Income Tax Return for 1990 for which the taxpayer made prepayments of approximately \$18,000,000. On February 18, 1992, the taxpayer filed an amended return and immediately began negotiating with the Department for a refund of the \$18,000,000. At the time of the filings, two audits of the taxpayer's tax records were underway by the Department. These audits covered the years 1988 through 1990 and were completed in 1995, resulting in an audited tax deficiency of approximately \$14,000,000. After taking into consideration the \$18,000,000 prepayment in 1991, the tax liability for the audited years totaled approximately \$32,000,000, exclusive of interest and penalties.

The Interim Secretary was appointed on August 4, 1995, and served in this position until January 8, 1998, a period of five months. On September 8, 1995, a meeting was held with Department officials and representatives from the taxpayer, one of whom was the brother of the then governor. Several other meetings were held with representatives of the taxpayer and the Department between September and December 1995. On December 21, 1995, the Interim Secretary signed an agreement with the taxpayer that covered the taxable years from 1984 through 1995. In signing the agreement, the Interim Secretary reduced the taxpayer's tax liability for the period 1984 through 1995 by approximately \$32,000,000, which in effect reduced the audited tax deficiency by approximately \$14,000,000 and allowed the Department to credit the taxpayer's account for approximately \$18,000,000, which was to be applied to the tax liability for 1995.

LEGISLATIVE AUDITOR

DEPARTMENT OF REVENUE STATE OF LOUISIANA Finding and Recommendation (Continued)

The audited tax deficiency of approximately \$14,500,000 was attributed to auditor adjustments for interest income and expense for 1987, 1988, 1989, and 1990; capital loss carry-forwards to 1990; and allocation of capital gains to Louisiana for 1987, 1988, 1989, and 1990. The reduction of the tax liability of approximately \$32,500,000 resulted because:

- The Department reduced the auditor adjustments for interest income and expense when the Department and the taxpayer settled on a different method, the revenue factor, for calculating interest income and expense.
- The Department subsequently allowed the taxpayer to include capital loss carry-forwards in computing taxable income.
- The Department adjusted the interest and overhead expense for all years and allowed the taxpayer to carry back net operating losses from 1991, 1992, and 1993 to 1990, and to carry forward net operating losses from 1993 and 1994 to 1995.

However, the auditor adjustments for capital gains allocable to Louisiana for 1987, 1988, 1989, and 1990, were not reduced, because the Department and the taxpayer agreed to accept these auditor adjustments.

Louisiana Revised Statute (R.S.) 47:343 requires that there shall be deducted a ratable portion of allowable deductions which are not directly attributable to any item or class of gross income. The statute does not provide for a specific method to determine how that ratable portion should be calculated. In the Louisiana Administrative Code (LAC) 81:1.1130.B.1 and 2, a formula is provided whereby the amount of interest expense that is applicable to investments that produce or that are held for the production of allocable income within and without Louisiana is calculated. It's also note that LAC 81:1.1130.B.3.f authorizes the Secretary of the Department "to adjust the allocation of interest expense and/or overhead expense applicable to investments which produce or which are held for the production of allocable income within and without Louisiana if he determines that such adjustment is necessary to clearly reflect apportionable and allocable net income."

Because the statutes do not provide for a specific method for determining the ratable portion of interest expense that is deductible from apportionable and allocable income, the existing regulations are constantly being challenged. The Secretary has broad powers, under the regulations, and may settle cases in varying ways among Louisiana taxpayers. This situation can result in inconsistent treatment. It appears that when a taxpayer does not choose to use the calculation method noted in the LAC, the taxpayer can submit a different method to the Secretary for approval.

In signing the agreement on December 31, 1996, the interim Secretary used the authority granted him by LAC 81:1.1130.B.3.f and accepted a revenue factor for calculating interest and

DEPARTMENT OF REVENUE
STATE OF LOUISIANA

Finding and Recommendation (Continued)

overhead expense allocable to Louisiana. Department officials stated that this method of allocating interest and overhead expense has never been used with any other taxpayer, although there have been a number of cases in which the Department deviated from the use of the formula described in LAC 61:1,113(B) 1 and 2. Use of the revenue factor gave the taxpayer a considerable reduction in taxable income. In addition, the revenue factor used did not consider all the revenue earned by the taxpayer from 1994 through 1995. The taxpayer had gross receipts from operations from 1991 through 1995, and the gross receipts were not used in establishing the revenue factor. By not considering all of the revenue earned during the period, the Interim Secretary thus reduced the taxpayer's taxable income even further. This method does not appear to be in the best interest of the State of Louisiana or consistent with methods required for other taxpayers. According to the agreement, the Interim Secretary also gave up the right of the Department to audit the five taxable years because the issues involved in the audit for the periods from 1985 through 1990 were the same issues that appear in the tax periods from 1991 through 1995.

Although the agreement states that the issues involved in the taxpayer's audit for the periods from 1985 through 1990 are the same issues that appear in the tax periods from 1991 through 1995, not all of those issues are the same. We identified the following issues that the Department should have considered before agreeing not to audit tax years 1991 through 1995:

- From 1984 until 1990, the taxpayer operated as a holding company. In 1990, the taxpayer changed from strictly a holding company to an operating company. Because the taxpayer changed its business structure, the company reported gross receipts from 1991 through 1995. Gross receipts were not reported during the 1984 to 1990 audits; therefore, gross receipts were not an audit issue, subject to verification.
- Capital gains of approximately \$143 million and ordinary gains of \$14 million were reported during 1991 through 1995. The taxpayer claimed that approximately \$64 million of this total was allocable to Louisiana.

By surrendering the right to audit the taxpayer and its subsidiaries for the taxable years 1991 through 1995, the Interim Secretary precluded the Department from verifying if the taxpayer allocated its gross receipts, capital gains, and ordinary gains in accordance with state laws and regulations regarding such allocation or apportionment.

In summary, the Interim Secretary may have exceeded his authority when he surrendered the Department's right to audit the taxpayer and its subsidiaries for the taxable years 1991 to 1995. In addition, by surrendering the Department's right to audit the taxpayer and accepting the revenue factor for allocating expenses, the Interim Secretary may have used inconsistent practices and afforded treatment to this taxpayer that has not been given to other taxpayers of the State of Louisiana.

LEGISLATIVE AGENCIES

DEPARTMENT OF REVENUE
STATE OF LOUISIANA
Finding and Recommendation (Concluded)

We question the propriety of entering into the agreement with the taxpayer and suggest that the Louisiana Legislature may want to review the broad authority given to the Secretary under LAC 85:1130 D.9.1 to ensure Louisiana's taxpayers are afforded equal treatment with regard to the payment of taxes.

Attachment 1

Management's Response



STATE OF LOUISIANA
DEPARTMENT OF REVENUE AND TAXATION

M. J. "Mac" Ferrin, Jr.
Governor

April 30, 1958

John Neely Kennedy
Secretary

Dr. Daniel G. Kyle, CPA, CFE
Legislative Auditor
Office of the Legislative Auditor
Post Office Box 94397
Baton Rouge, Louisiana 70804-9397

RE: Legislative Auditor's Report on Financial Related Audit of the
Louisiana Department of Revenue

Dear Dr. Kyle:

I have received and read the captioned report. I write to provide the official response on behalf of the Louisiana Department of Revenue that you have requested.

As you and I have discussed, the Department's position with respect to your report is that the report speaks for itself. I was not employed by the Department of Revenue in 1955 and, therefore, have no first-hand knowledge of the facts and circumstances surrounding the settlement discussed in your report. For that reason, it is impossible for me to take an official position on behalf of the Department as to the merits of the report's allegations and conclusions.

The report mentions only one Department of Revenue employee. Then and now, the settlement of a dispute between the Louisiana Department of Revenue and a taxpayer requires the review and approval of the settlement by numerous people, one of whom is the Secretary. The Civil Service employees who approved the subject settlement in 1955 and who negotiated it have asked me to provide you with their response to your report. A copy is attached. These employees have also asked me to respectfully ask you to attach their response to the report.

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Dr. Daniel G. Kyle, CFA, CFE
April 30, 1998
Page 2

As always, please feel free to contact me if you have any questions.

Sincerely,

John N. Kennedy
Secretary

JNK/td
Attachment

cc: Hon. M. J. "Mike" Foster, Jr.
Governor



STATE OF LOUISIANA
DEPARTMENT OF REVENUE AND TAXATION

M. J. "Max" Foster, Jr.
Governor

John Henry Keady
Secretary

April 25, 1998

Dr. Daniel G. Kyle, CPA, CFE
Legislative Auditor
Office of the Legislative Auditor
Post Office Box 54397
Baton Rouge, Louisiana 70804-9397

RE: Legislative Auditor's Report: "Department of Revenue and Taxation,
State of Louisiana Financial Related Audit"

Dear Dr. Kyle:

We are the State employees employed by the Louisiana Department of Revenue who negotiated, approved and conducted the settlement your office criticized in the captioned report. This is our response to your report.

Please consider the following facts:

1. This settlement was the settlement of a lawsuit and other claims involving millions of dollars against the State of Louisiana. The taxpayer gave up certain monies it was claiming (but which had not yet been awarded by a court) and the Department of Revenue gave up certain monies it was claiming (but which had not yet been awarded by a court), all as a part of the settlement. We negotiated hard on behalf of the State of Louisiana and at all times acted in good faith. This settlement was in the best interest of the State of Louisiana. We repeat: this settlement was in the best interest of the State of Louisiana. The gross amount of tax on the table prior to commencement of our discussions with the taxpayer was \$80,647,017. Of this \$80,647,017, the settlement reduced that amount by \$3,826,461 by agreeing to use a revenue ratio for the computation of interest expense. Accordingly, the remaining \$74,220,556 was either paid in cash by the taxpayer, absorbed by net operating loss carrybacks or capital loss carryforwards, or extinguished by

operating loss carrybacks or capital loss carryforwards, or extinguished by offset against taxpayer's refund claims. This was more than a good deal for our State given the uncertainties of litigation.

2. Our Department has enjoyed a close working relationship with your auditors for many years, and we hope that relationship will continue. However, while we respect your auditors as well as the position and authority of your office, we respectfully submit that your auditors are not qualified to evaluate the merits of the lawsuit, the other legal claims or the settlement, all of which involved complex provisions of Louisiana corporate income and franchise tax, any more than we or other tax accountants in the Department of Revenue would be qualified to opine on complex issues of government accounting, on which your auditors are experts. We submit that if the settlement we conducted was submitted for review to any independent tax professional, experienced in the field of Louisiana corporate income and franchise tax, that individual would disagree with your report and agree with the course of conduct taken by the Department of Revenue. This statement is not meant to be personal. However, the fact remains that the employees of the Department of Revenue who negotiated, approved and conducted the settlement have between them in excess of 100 years of experience in Louisiana corporate income and franchise tax. Your auditors who conducted this examination collectively have less than one-year experience. Your auditors are simply wrong.
3. Your report criticizes the discretion and decision-making of the "Interim Secretary." Louisiana law does not provide for the status of "Interim Secretary." One is either Secretary of a Department or he is not. Further, according to written procedures within the Department of Revenue that have been in effect since 1972, (see the attached copies of Policy and Procedure Memoranda No. 38.1 and 30.2 in effect at the time of the settlement agreement), five other senior departmental employees must concur in writing with the Secretary for an adjustment to be made under LAC 61:1174(B)(9)(C). Your report implies that the Secretary of this Department has the authority to act unilaterally and acted unilaterally in reaching this settlement. This is not accurate.
4. Your report is also in error because it fails to mention that two of the adjustments made in the taxpayer's favor (the net operating loss carryback and the capital loss carryforward), which together gave the taxpayer a tax

reduction of \$28.5 million, were deductions to which the taxpayer was clearly entitled under well-settled law. Ask any experienced independent tax practitioner and he or she will tell you the same thing. The field auditor who conducted the audit did not give the taxpayer those deductions to which it was clearly entitled. It is a part of our job at the main office of the Department of Revenue in Baton Rouge to correct the mistakes of field auditors and act as an interim administrative appeals level for taxpayer audit grievances. You should also know that the field auditor who conducted this audit spent over two years (repeat: two years) in the taxpayer's office auditing its books. No one should have to go through a two-year audit. What's more, no one should have to go through a two-year audit and then have the auditor raise a \$28.5 million deduction the taxpayer was clearly entitled to. The upshot of this is that the adjustments we made in Baton Rouge did not "give" the taxpayer \$31 million as your report suggests. Of the alleged \$31 million give away, \$28.5 million was reduced by our Audit Review Division before resolution discussions commenced with taxpayer. Yes, we in the main office in Baton Rouge made these adjustments. We make no apologies for following the law.

5. Your auditors also apparently failed to consult the relevant corporate income and franchise tax law at the time of the settlement of this lawsuit. Had they done so, they would have seen that the law in Louisiana at that time was Act 690 which was passed by the Legislature in 1993. See Acts 1993, No. 690. As part of the settlement, we required the taxpayer to give up its rights to avail itself of the advantages provided to it under this Act. This concession by the taxpayer resulted in an additional \$23 million paid to the State of Louisiana as a part of our negotiations. While it's true that Act 690 was declared unconstitutional by the Louisiana Supreme Court three years later, at the time of this settlement, a district court had already upheld its constitutionality. It was the law at the time the agreement was consummated.
6. Your report takes issue with the Department's alleged agreement not to audit the taxpayer for the tax years 1991 through 1995. This, too, is inaccurate. The Department absolutely maintained its right to audit those years and in fact did audit the returns for those years. The method used in auditing those years is called a desk audit. Our agreement to forego a field examination for those years is a frequent and accepted practice of the Department. (After all, the field auditor had already spent two years in the offices of the taxpayer auditing its books). A desk audit is performed on 50% of the total cases audited by the

Department of Revenue. The Department also retained and continues to retain the right to audit taxpayer's compliance with the settlement agreement.

7. We attended one meeting with the taxpayer's representatives, when the brother of the then-Governor of Louisiana was present. We did not invite the Governor's brother; he came with other representatives of the taxpayer. There were 15 people in the meeting; 4 representing the taxpayer and 11 Department of Revenue employees. What your report neglects to mention is that the Governor's sibling is and was a registered lobbyist for the taxpayer. Our understanding of Louisiana law is that there's no prohibition against a brother of the Governor being a registered lobbyist or a taxpayer's representative. Perhaps there should be, but that is not our decision. Given the fact that it is legal for the Governor's brother to be a lobbyist, and given the fact that one has a constitutional right to petition his government, including through professional representatives, what would you have had us to do? Should we have refused to attend a meeting with this person because we did not like his or his brother's politics? We pride ourselves at the Department of Revenue on treating everyone the same. We try to meet with any taxpayer that wishes to meet with us and any properly mediated representative of a taxpayer who asks to meet with us. It would be neither fair, legal nor appropriate for us to pick and choose among which taxpayer representatives we are willing to talk to. Moreover, your report implies that the Governor's brother used undue influence to force us to conduct a settlement. That simply is not true and we respectfully ask you to come forward immediately with any evidence to support your allegations.

8. Your report suggests that there is something inappropriate about a field audit being changed when it is reviewed by senior personnel in Baton Rouge. The truth is that over 70 percent of all field audits are changed in one way or another by Audit Review, and of that 70 percent, over half of the total amount of field audit findings are reduced and removed by Audit Review. Field auditors are generally less experienced than those in Baton Rouge who review their work, and it is our job in the Baton Rouge main office to make certain that a taxpayer in Lafayette is treated the same way as a taxpayer in Monroe. Therefore, many audits change. This audit changed and should have changed as a result of appropriate adjustments being made to which the taxpayer was and is clearly entitled under well-settled law. There is nothing unusual about that. It happens every day at the Department of Revenue.

9. Your report states that we employed a method of allocating interest and overhead expense of the taxpayer that "has never been used with any other taxpayer." This, too, is inaccurate. We supplied your staff with numerous cases in which the Department has deviated from the asset formula. You must understand that the State statute on which the regulation you question is based has been in our law since Louisiana's earliest income tax enactments. Its relevant portions were lifted from a bill which became the Internal Revenue Code of 1915. At that time, interest expense and overhead deductions were calculated using a REVENUE RATIO, exactly as the Department did in this case and to which your auditors take exception. Over time, legitimate exceptions were made for the oil and gas industry to use an expense ratio, which we borrowed from the IRC provisions dealing with depletion. Again, with the passage of time, this exception became the primary rule; and, even later (1957) an asset formula was put into regulation form. The Department's long standing administrative construction of the applicable statute and regulations has been, since 1957, to require an asset formula for the computation of interest expense, unless the taxpayer proposes a method which is both reasonable and which also clearly reflects net income. Experience has taught us that indirect expenses are difficult to attribute with fairness by the use of a one-formula-fits-all approach. The federal government agrees. See Office of Management and Budget Circulars A-87 and A-122 relative to allocation of indirect costs.
10. Your auditors also found that gross receipts were not taken into account in computing a revenue ratio, nor should they have been. Throughout this special examination, your auditors have consistently confused allocable income with apportionable income and gross income with gross receipts; it is not surprising that they do not understand our use of a revenue formula. You must know that you have us at a disadvantage with these types of allegations. You are apparently free to take public sound-bite shots at us with impunity, while we can respond only in a limited fashion, as we are handcuffed by R.S. 47:1508, relative to confidentiality of taxpayer information.
11. Finally, your auditors question the broad authority given the Department under our regulation LAC 41:1130(B)(5)(f). The Louisiana Legislature, in its wisdom, can narrow, broaden or leave intact the statutory discretion of any agency of government within constitutional constraints. However, we respectfully suggest that to remove all legal discretion from an administrative

agency with quasi-legislative and quasi-judicial powers would be a mistake ... as much a mistake as not having a Legislative Auditor to protect the integrity of the Legislature's appropriations and Louisiana's fiscal position.

In conclusion, the settlement we reached with this taxpayer was in the best interest of the State of Louisiana. We made a good deal for the people of our State and we are proud of it. If you ask any independent person with competence in Louisiana corporate income and franchise tax, he or she will agree.

Respectfully, your report is simply wrong.


Ben Morrison
Mike Pearson
Virgil Brady
Alvin C. Smith
Donald Landry

Attachments