#1

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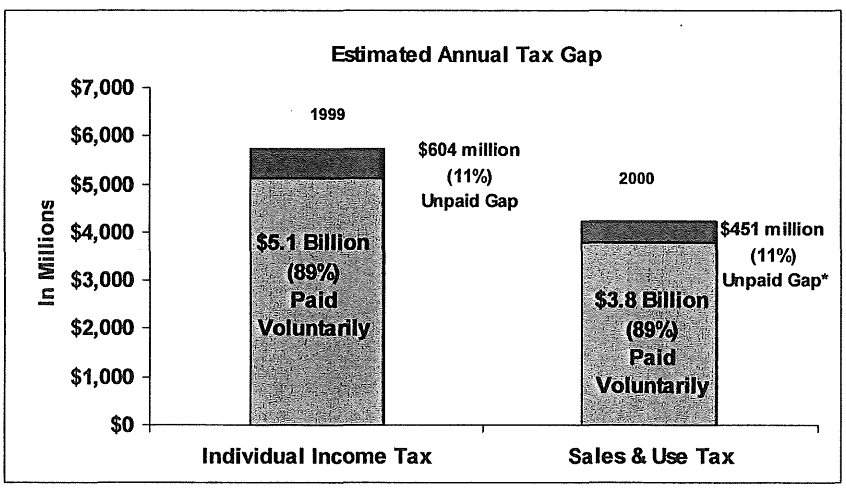
The Compliance Issue



*The Sales Tax Gap is projected to be about $700 million by 2007.

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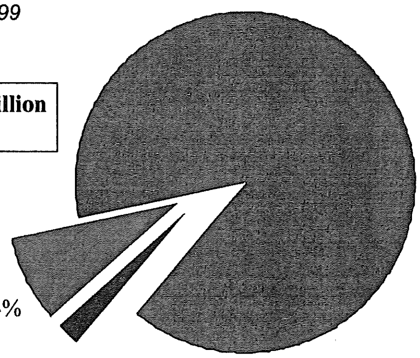
Minnesota Individual Income Tax Gap Study

Minnesota individual income tax as percent of total tax due

Calendar Year 1999

Total gap = $604 million
10.5% of total



Individual income tax voluntary collections
$5.1 billion or 89.5%

Underreporting
$479 million or 8.4%

Nonfilers
$124 million or 2.2%

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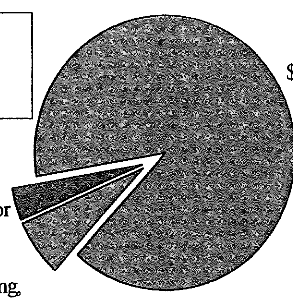
Minnesota Sales and Use Tax Gap Study

Minnesota Sales tax as percent of total tax due

Calendar Year 2000

Tax gap = $451 million
11% of total



Sales Tax voluntary collections, $3.8 billion or 89%

Nonfilers*, $163 million or 4%

Underreporting, $288 million or 7%

* Nonfilers include $88 million from businesses and $75 million from households. Nonfilers will continue to increase with the growth of internet sales.

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Compliance Audits

The department conducted 71,923 audits in FY 2004.

Tax Type	Office	On-site
Income Tax	**38,681**	**7,736**
Corporate Tax	**3,599**	**738**
Partnership, Fids, & Estate Txs	**2,073**	**601**
Sales & Use Tx	**3,468**	**2,854**
Tax Operations/Early Audit	**12,172**	
TOTAL	59,993	11,930
% of TOTAL	83%	17%

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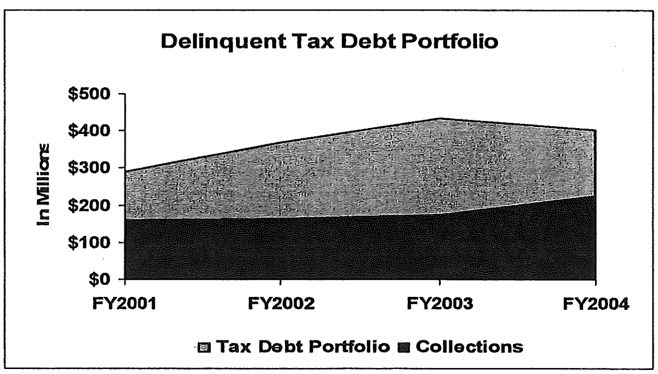
Delinquent Tax Debt Portfolio



	FY2001	FY2002	FY2003	FY2004
Delinquent Tax Debt	$290	$370	$436	$404
Collections	$160	$164	$174	$225

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Enforcement Collection Activities

In FY 2004, the department managed:

- 178,000 delinquent tax debt cases and an average of $404 million in delinquent tax debt.
- 170,000 delinquent non-tax debt cases and an average of $263 million in delinquent non tax debt.
- $225 million was collected in delinquent tax debt and $24 million in delinquent non-tax debt.

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The Streamline Sales Tax Project (SSTP)

What is it?
Minnesota is one of 39 states and the District of Columbia to participate in a multi-state effort to simplify and modernize sales tax collection and administration.

Project participants:
Businesses, state revenue departments, representatives of state and local governments.

How does it work?
It provides for uniform definitions of products and relies on emerging technology to reduce the burden of tax collection on all retailers

Overall expected project outcome?
It will help improve fairness for Minnesota-based brick-and-mortar businesses facing competition from internet retailers.

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History of Tax Compliance Initiatives

Dollars in thousands

Biennium	Initiative Name	Appropriation	Revenue Target	Actual Revenues	% of Target
FY 2002-03	**Tax Compliance**	**$5,164**	**$32,403**	**$52,494**	**162.0%**
	Tax Compliance II	**$2,569**	**$7,637**	**$17,362**	**227.3%**
	Non-Filer Initiative	**$1,996**	**$20,070**	**$27,376**	**136.4%**
	Subtotal	$9,729	$60,110	$97,232	161.8%
FY 2004-05*	**Tax Compliance**	**$12,838**	**$59,838**	**$63,974**	**106.9%**
	Subtotal	$12,838	$59,838	$63,974	106.9%
	Grand Total	$22,567	$119,948	$161,206	

**FY 2004-05 reflects revenue data captured through the end of November 2004*

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Our challenges. . .

- An increasing number of citizens believe that cheating on taxes is okay. An IRS survey reveals that 17% think it is all right to cheat on taxes, up from 11% just two years ago.
- More and more, taxpayers are challenging state tax laws. Simultaneously, tax law and accounting firms have become more aggressive in soliciting clients.
- As businesses move from paper to electronic records and transactions, our employees need more skills and better technological tools to enable them to understand, access and audit various computer systems, as well as the transactions.
- Consolidations and mergers among businesses have resulted in the merging of computer systems, making it more difficult to identify transactions and determine who is responsible for paying the tax.

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Other important challenges:

- Technology support and data warehouses

- Compliance support: 52% in 2002; now 37%

- Work force issues:
  - ➢ Increased competition for accounting professions – since July 2004, of every entry level accountant we hired, 1 out of 2 (56%) is now gone.

  - Aging labor force – employees age 60 or older:
    - ➢ By 2015: 1 out of 2 (49%) employees
    - ➢ By 2010: 1 out of 4 (27%) employees

  - More training and fewer trainers

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Expanded Tax Compliance Initiatives

FY 2004 – 2005

Report to the Minnesota Legislature

January 2005

Laws of Minnesota 2003, First Special Session,
Chapter 1, Article 1, Section 15, Subdivision 2.

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Summary of Findings

The Minnesota Legislature appropriated $12.8 million to the Department of Revenue for the 2004-05 biennium to collect $59.8 million through expanded tax compliance activities (Laws of Minnesota 2003, First Special Session, Chapter 1, article 1, section15, and subdivision 2). This report summarizes the results the department has achieved through the end of November 2004, and is the second of two reports for the biennium. During this period — with 71 percent of the biennium completed — the department has:

- Collected and deposited in the general fund $63.9 million, or 107 percent, of the anticipated $59.8 million sought through the tax compliance initiatives.

- Resolved a total of 14,028 noncompliant individual income tax cases.

- Identified a total of 590 noncompliant sales and use tax payers and 732 noncompliant corporate tax payers.

- Expended $6.6 million and hired 109 full-time equivalents (FTEs).

To collect the $63.9 million to date, the department spent $6.6 million, or approximately $1 for every $8 collected. In the remaining months of the FY 2004-05 biennium, the department expects to further exceed the $59.8 million legislated goal.

Expanded Tax Compliance Initiatives Report 2004

This report was prepared by the Minnesota Department of Revenue (the department) and developed for the legislature in response to a legislative directive (Laws of Minnesota 2003, First Special Session, Chapter 1, article 1, section15, subdivision 2). Copies of this report are available on the Department of Revenue website at www.taxes.state.mn.us.

Cost of report preparation: $25 x 20 hours = $500.
Report printing cost: $100.
Total estimated cost of this report: $600.

Purpose of this Report

This is the second of two reports by the department for the FY 2004-05 biennium. It provides performance results in accordance with the 2003 session mandate.

For the FY 2004-05 biennium, the department was appropriated $12.8 million from the general fund to identify and collect tax liabilities from individuals and businesses that currently do not pay taxes owed. This initiative is expected to result in new general fund revenues of $59.8 million by the end of the biennium.

The 2003 session mandate directs the department to report performance results for the following:

- The number of non-compliant corporate taxpayers each year and the percentage and dollar amount of valid tax liabilities collected;
- The number of non-compliant sales and use taxpayers each year and the percentage and dollar amount of the valid tax liabilities collected;
- The number of non-compliant individual income tax cases resolved each year and the percentage and dollar amount of valid tax liabilities collected; and
- Base level expenditures and staff positions provided at the budget activity level related to compliance and audit activities, including baseline information as of January 1, 2002.

The department's progress as shown by these performance indicators was first reported in detail in March 2004. The first report provided background and a description of how the expanded tax compliance initiative was implemented within the department. As a follow-up to the first report, the focus of this report is to provide a status update of the mandated performance indicators for the FY 2004-2005 biennium. Biennium-to-date results referenced in this report reflect the time period of July 2003 to November 2004.

This report is organized into four sections:

I. FY 2003 Compliance and Enforcement Base Performance
II. FY 2004-05 Expanded Tax Compliance Initiative Performance
- Year-to-Date Expenditures/Full-Time Equivalents (FTEs) Hired
- Year-to-Date Revenues

III. Observations and Trends
IV. Appendix - Methodology

I. FY 2003 Compliance and Enforcement Base Performance

A key element of the department's strategic plan is to ensure that *everyone pays the right amount, no more, no less*. To make this vision operational, the department is focusing on methods for measuring compliance with Minnesota's tax system.

Recently, the department conducted two landmark studies to measure the tax gap—the difference between the amount of taxes actually paid and the amount of taxes that should have been paid. The first of the two studies, conducted in 2002, revealed a *sales tax gap* of about $500 million; that is expected to grow to $700 million by 2007. Similarly, in 2004, the agency, in consultation with the State Demographer's Office and the Minnesota Department of Finance, conducted a study of the *individual income tax* utilizing the 2000 Census information. This study revealed an annual gap of about $604 million.

To eliminate or minimize this gap, the department is conducting the following activities in order to pursue noncompliant taxpayers including, but not limited to: (1) auditing of taxpayer filings to correct errors and detect abuse; (2) identifying taxpayers who should file, but did not ("nonfilers"); (3) identifying unreported taxable activity; (4) providing taxpayer outreach and education programs; and (5) pursuing collection activities on delinquent accounts. In Table 1.0, the department provides an estimate of dollars expended and revenues generated as a result of audit and compliance activities conducted in FY 2003 from the major tax types administered in the department.

For the tax types listed in table 1.0, assessments are made from audits. The taxpayer generally has 60 days to appeal any assessment before the case is sent to the Collection division for collection. Appendix A shows the methodology for Table 1.0.

Table 1.0
FY 2003 Estimated Direct Compliance and Enforcement Activity Base Revenue

Tax Type/Function	FTE	Estimated Compliance Revenues	Estimated Expenditures	Ratio (rev:exp)
Collection	160	$171,812,750	$ 9,727,883	17.7
Individual Income Tax	105	$ 9,788,237	$ 6,053,459	1.6
Withholding	7	$ 414,224	$ 361,049	1.2
Sales and Use/Corp Taxes	167	$ 74,992,995	$11,116,474	6.7
Special Taxes	36	$ 4,100,155	$ 2,115,699	1.9
Tax Operations	26	$ 14,470,883	$ 1,321,015	11.0
TOTAL	*501*	*$275,579,244*	*$30,695,579*	*8.9*

The base revenues generated from all audit and compliance activities is a function of multiple variables such as the retention of experienced revenue tax specialists (RTS), as well as the number of analytical software applications tools deployed by the department for audit selection. The ratio of revenues to expenditures continues to remain high, despite recruitment and retention issues that are described in detail in section III.

II. Performance of the FY 2004-05 Expanded Tax Compliance Initiative

Expenditures and Full-time Equivalents

As of November 30, 2004, the department has spent approximately $6.6 million for this initiative for the FY 2004-2005 biennium. Payroll is the largest expenditure category accounting for 84 percent of total expenditures. Table 2.0 shows these expenditures in detail.

Table 2.0.
FY 2004-05 Expanded Tax Compliance Expenditures through 11/30/04

	Expenditures	% of Total
Payroll	$5,631,749	84%
Contractual	$ 12,014	0%
Equipment	$ 460,797	7%
Supplies	$ 82,540	1%
Technology	$ 237,500	4%
Other	$ 243,601	4%
Total	*$6,668,201*	*100%*

On average, it takes the department approximately one to two months to fill positions for this initiative. Table 2.1 shows the number of staff hired to date. Since July 2003, approximately 109 FTEs have been hired in the Revenue Tax Specialist (RTS) or Revenue Collection Officer (RCO) classifications.

Table 2.1
Expanded Tax Compliance Initiative FTE

	FY 2004 Actual	FY 2005 YTD Actual	FY 2004-2005 planned
Initiative FTEs	66	109	133

Revenues

As described in the first report, to improve compliance overall, noncompliant taxpayers must be identified and noncompliant cases must be resolved. Table 2.2 shows, as mandated, the number of individual income tax noncompliant cases resolved and the number of taxpayers that are not in compliance with the sales and use and corporate tax laws.

For individual income tax, the number of noncompliant taxpayer cases resolved as a result of the tax compliance initiative is 14,028. An individual income taxpayer case is resolved if the following occurs:

- The auditor files a return for a nonfiling taxpayer; or
- The auditor is able to get the nonfiling taxpayer to file a return;
- The auditor completes an audit report. This audit report may indicate a balance due, a refund or no change to the return.

The "noncompliant" criteria are slightly different for businesses and corporations. Businesses are identified as noncompliant with the tax laws if the audit or other compliance actions result in a change in taxpayer liability.

Additional revenue is generated from the compliance actions listed in Table 2.2. The expanded tax compliance initiative provides funding to increase audit and collection activity. The department has selected these tax types to be the focus of the expanded direct compliance efforts: income tax, sales and use tax, corporate tax, insurance tax, gambling tax and withholding tax.

Table 2.2
FY 2004-05 Year-To-Date Non-Compliance with the Tax System

	Non Compliant Cases "Identified" FY 2004-05 to Date	Non Compliant Cases "Resolved" FY 2004-05 to Date
Individual Income Tax System	--------	14,028
Sales and Use Tax System	590	-------
Corporate Tax System	732	-------
TOTAL[1]	***1,322***	***14,028***

Through the end of November 2004 (with 71 percent of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is $63.9 million. Table 2.3 provides detailed data related to the total revenues collected for each tax type/function from this initiative. By the end of FY 2005, the department expects to further exceed the legislated goal.

Table 2.3
Biennium Year-To-Date Compliance Initiative Revenue Results

Tax Type/Function	Actual Compliance Collections	Biennium Target	% of Target Achieved
Collection	$34,192,648	$32,887,000	104%
Individual Income Tax	$8,307,758	$6,371,000	130%
Withholding	$1,777,142	$2,295,000	77%
Sales and Use/Corp Taxes	$13,295,378	$16,282,000	82%
Special Taxes	$3,501,412	$1,001,000	350%
Tax Operations Early Audit[2]	$2,900,170	$1,002,000	289%
TOTAL	***$63,974,508***	***$59,838,000***	***107%***

[1] This total excludes taxpayers noncompliant with the withholding tax system. The Withholding Tax Division has identified 1,917 taxpayers as noncompliant with the withholding tax system as result of the tax compliance initiative. The criteria for a taxpayer being identified as noncompliant with the withholding tax system is as follows:

a. Withholding income tax but not remitting it;
b. Withholding income tax but not depositing it in a timely manner; or
c. Not withholding income tax when they should have.

[2] In Table 2.3, for Tax Operations Early Audit, January 2004 is the first month that initiative collections were reported. The amount in this table for Tax Operations Early Audit includes collections from refund reductions only. Collections for payments received from accounts receivable and refund offsets are not included in this table because this data was not available when the report was compiled. This data will be included in the final report for the expanded tax initiatives of the FY 2004-05 biennium.

III. Observations and Trends

Although expanded tax compliance activities are generating substantial revenue, improving tax compliance with the tax system remains a challenging task. Staff retention is a growing concern. Since July 2001, the department has received additional funding to fill staff positions for the tax compliance initiatives. The revenue production from direct compliance activities is related to the actual number of positions in the RTS and RCO classifications working in the field. Turnover from these position classifications has a direct impact on revenues generated as a result of direct compliance activities. From FY 2002 to FY 2004, the turnover rate (the ratio of new hires to the number of resignations) has increased in the combined RTS classification from 11 percent to 24 percent. This turnover rate is twice the national average. Within the RTS specialist classification, another trend involves the rate of resignations for this classification within one year of service. In FY 2003, 50 percent of RTS specialists who resigned had served one year or less. In FY 2004, 79 percent of the RTS specialists who resigned served one year or less. In response to this trend, the department has initiated focus groups to help identify strategies to retain employees in this classification.

Other trends confronted by the department affecting tax compliance to note:

- An increasing number of citizens believe that cheating on taxes is all right. An IRS survey reveals that 17 percent of the nation’s taxpayers think it is all right to cheat on taxes, up from 11 percent just two years earlier.
- More and more, taxpayers are challenging state tax laws. Simultaneously, tax law and accounting firms have become more aggressive in soliciting clients by offering to challenge tax laws and the department’s interpretations.
- The tax laws are growing more complex. As the number of tax credits, deductions and special provisions grows, the greater the complexity, length of time, and expense of conducting audits.
- As businesses move from paper to electronic records and transactions, the department’s employees need more training to enable them to understand and access various computer systems to ensure the accuracy of the systems, as well as the transactions.
- The department continues to increase the number of accounts receivable dollars collected and cases resolved. The total number of remaining delinquent accounts and dollars available for collection is constant.
- Globalization of commerce increases the number of transactions that cross state and nation borders. As more transactions are made through mail-order firms and the Internet, it is more difficult and expensive for the department to identify them and determine who is responsible for paying the taxes.

IV. Appendix – Methodology

Table 1.0

a. Expenditures:

The base for compliance activity expenditures in FY 2003 was derived by compiling payroll expenditures for the number of full-time equivalents (FTE) engaged in compliance and enforcement activities. These FTEs were identified by management in each tax type/ functional area. Payroll expenditures for FTEs were extracted from the Information Access (IA) warehouse. Employer payroll tax, retirement and insurance were included in the data extraction. The count of FTEs was derived by the total number of hours worked in FY 2003 and divided by 2,088.

b. Revenues:

Collections:
The base consists of total collections as reported in the Lotus Notes database called MCE Performance FY 2003. The total of "tax debt" is the sum of payments collected, minus bad checks.

Sales and Use Tax:
The estimate for base collections is derived from a rolling average of estimated (or actual) collections over a period of four fiscal years, FY 2000 to FY 2003. Included in this estimate are the following compliance activities:

- Actual dollars collected from field and managed audits within 90 days of the order date including claims denied, remaining claims applied, and interest paid on claims allowed that was applied. The estimate does not include the additional claims/credits found during an audit by a revenue tax specialist.
- Dollars from nexus voluntary disclosure. It assumed that 100 percent is collected on liability reported.
- Dollars from nexus investigations. It is assumed that 85 percent is collected from liability reported and assessed.
- Dollars from office audits. It is assumed that 50 percent is collected on assessments.
- Dollars from self-reviews. It is assumed that 100 percent is collected on additional tax reported.
- Dollars from non-filers. It is assumed that 50 percent is collected on assessments.

Corporate Tax:
The estimate for base collections is derived from a rolling average of 3 fiscal years, FY 2001 to FY 2003. Included in this estimate are the following compliance activities:

- Dollars collected from payments paid on proposal as a result of additional tax assessments as recorded in the corporate inventory system.
- Dollars collected from payments received from nexus activities.

- Dollars collected as a result of edit activity on estimated payments. The amounts captured include reduced claimed refunds and reduced claimed overpayments to be carried forward next year.
- Dollars collected from claims denied. If the audit results in additional tax being assessed, only the reduction of the claim to zero is included. For this base estimate in this report, a nine-year average of claims denied is used.
- Over assessments from audits that result in refunding tax as recorded in the corporate inventory system.

Individual Income Tax:
The estimate for base collections is derived from a rolling average of three fiscal years, FY 2001 to FY 2003. Included in this estimate are the following compliance activities:

- Dollars collected from payments received during the proposal period for office audits, field audits and non-filer audits.
- Dollars collected from refunds denied during the early audit phase of processing a tax return.

Withholding Tax:
The estimate for base collections is derived from dollars paid on proposal during the first 90 days of the tax order date, minus dollars transferred out and refunded.

Special Taxes:
The estimate is derived from assessments from direct compliance activities from the following taxes: gambling, insurance, solid waste management, metropolitan landfill contingency action trust fund (MLCAT), dry cleaner, cigarette, tobacco, occupation, liquor, wine, malt beverages, common carrier, mortgage and deed, MinnesotaCare and mining tax. For the taxes listed, except MinnesotaCare, it is assumed that 100 percent is collected from additional tax assessments made. In FY 2003, one MinnesotaCare assessment was excluded from this computation because it has been appealed to the Supreme Court.

Tax Operations:
The estimate is based on calendar year 2003 and includes the following:

- Refund reductions from current and prior year returns including: tax year 1996 and prior years, M-1 returns, M-1X returns PR-X returns, PR returns, and political contribution refund returns;
- Payments received from accounts receivable during 90 days of the tax order date; and
- Refund off-sets which took place during the 90 days of the tax order date.