MINNESOTA · REVENUE

Expanded Tax Compliance Initiatives

Fiscal years 2006 – 2007

Report to the Minnesota Legislature

March 2006

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To the members of the legislature of the state of Minnesota:

The Minnesota Legislature appropriated $17.8 million to the Department of Revenue in the 2006–07 biennium to generate an added $90.7 million in revenue through stepped up tax enforcement activities. This is the first of two reports on progress toward achieving this goal.

(The appropriation to the increased tax compliance activities was authorized by the legislature under Laws of Minnesota 2005, Chapter 156, Article 1, Section15, subdivisions 2 and 3.)

As of December 31, 2005, the department spent $2.4 million of the approximately $17.8 million appropriated. This expenditure has led to the collection of $17.1 million, or 19 percent of anticipated $90.7 million for the biennium.

Of the $17.1 million collected,

- $10.8 million was generated from identifying nonfilers and increasing the number of audits of individuals and businesses, including the payers of lawful gambling taxes, insurance taxes, tobacco taxes and alcoholic beverage taxes.
- $6.3 million was produced from increases in delinquent tax collection activities.

Based on the results to date, the department is on track to collect the estimated $90.7 in added revenue for the biennium. The department is generating about $7 in added revenue for every $1 spent on these expanded tax enforcement activities.

Revenue gains from increased tax enforcement efforts are generally slowest during the initial months, primarily due to the time required to hire and train new employees. Now that the department has completed the initial hiring and training process, the revenue gains should accelerate.

The activities described in this report are a part of the department's on-going effort to identify and address patterns of noncompliance with the state's tax laws. Copies of this report are available at www.taxes.state.mn.us.

Please contact me if you need additional information about the results achieved in this report.

Sincerely,

Daniel A. Salomone
Commissioner

Laws of Minnesota 2005, Chapter 156, Article 1, Section 15, Subdivision 2-3.

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Summary of Findings

The Minnesota Legislature appropriated $17.8 million to the Department of Revenue for the 2006-07 biennium to collect $90.7 million through expanded tax compliance activities (Laws of Minnesota 2005, Chapter 156, article 1, section 15, and subdivision 2-3). This report summarizes the results the department has achieved through the end of December 2005, and is the first of two reports for the biennium. During this period — with 25 percent of the biennium completed — the department has:

- Collected and deposited in the general fund $17.1 million, or 19 percent, of the anticipated $90.7 million sought through the tax compliance initiatives.
- Resolved a total of 7,937 noncompliant individual income tax cases.
- Identified a total of 420 noncompliant sales and use tax payers and 435 noncompliant corporate tax payers.
- Expended $2.4 million and hired 92.9 full-time equivalents (FTEs).

To collect the $17.1 million to date, the department has spent $2.4 million, or approximately $1 for every $7 collected. In the remaining months of the FY 2006-07 biennium, the department expects to achieve the legislated goal.

Expanded Tax Compliance Initiatives Report 2006

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 2005, Chapter 156, article 1, section15, subdivision 2-3). Copies of this report are available on the Department of Revenue website at www.taxes.state.mn.us.

Cost of report preparation: $28 x 30 hours = $840
Report printing cost: $25.
Total estimated cost of this report: $865.

Purpose of this Report

This is the first of two reports by the department for the FY 2006-07 biennium. It provides performance results in accordance with the 2005 session mandate.

For the FY 2006-07 biennium, the department was appropriated $17.8 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 $90.7 million by the end of the biennium.

The 2005 session mandate directs the department to report performance results for the following:

- The number of noncompliant corporate taxpayers each year and the percentage and dollar amount of valid tax liabilities collected;

- The number of noncompliant sales and use taxpayers each year and the percentage and dollar amount of the valid tax liabilities collected;

- The number of noncompliant 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, 2004.

The first report provides background and a description of the current performance of the expanded tax compliance initiative within the department. Biennium-to-date results referenced in this report reflect the time period of July 2005 to December 2005.

This report is organized into four sections:

I. FY 2004 Compliance and Enforcement Base Performance

II. FY 2006-07 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 2004 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.

The department conducted two 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. The second study, conducted in 2004, focused on the individual income tax. This study revealed an annual gap of about $604 million.

To eliminate or minimize these gaps, the department is conducting the following activities in order to pursue noncompliant taxpayers, including, but not limited to: (1) auditing 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 from audit and compliance activities conducted in FY 2004. For the tax types listed in table 1.0, assessments are made from audits. The taxpayer generally has 90 days to appeal any assessment before the case is sent to the Collection Division for enforced compliance. Appendix A describes the methodology for Table 1.0.

Table 1.0
FY 2004 Estimated Direct Compliance and Enforcement Activity Base Revenue

Tax Type/Function	FTE	Estimated Compliance Revenues	Estimated Expenditures	Ratio (rev:exp)
Collection	212.6	$ 237,944,307	$12,860,841	18.5
Individual Income Tax	113.3	10,006,215	6,414,008	1.5
Withholding	10.2	1,708,873	517,932	3.3
Sales and Use/Corp Taxes	185.0	84,789,980	12,136,735	6.9
Special Taxes	34.0	4,629,019	2,074,556	2.2
Tax Operations	29.5	23,770,893	1,509,403	15.7
TOTAL	584.6	$ 362,849,287	$35,513,475	*10.2*

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 2006-07 Expanded Tax Compliance Initiative

Expenditures and Full-time Equivalents

As of December 31, 2005, the department has spent approximately $2.4 million for this initiative for the FY 2006-2007 biennium. Payroll is the largest expenditure category accounting for 87 percent of total expenditures. Table 2.0 shows these expenditures in detail.

Table 2.0.
FY 2006-07 Expanded Tax Compliance Expenditures through 12/31/05

	Expenditures	% of Total
Payroll	$2,094,201	87.43%
Contractual	-	0%
Equipment	$73,350	3.06%
Supplies	$5,380	.22%
Travel	$63,904	2.67%
Other	$158,380	6.61%
Total	*$2,395,215*	*100.00%*

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 2005, approximately 92.9 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 2006 YTD Actual	FY 2007 Planned	FY 2006-2007 Planned
Initiative FTEs	92	144	144

<u>Noncompliant Taxpayers and noncompliance cases</u>

The expanded tax compliance initiative provides funding to increase audit and collection activity. The tax types selected to be the focus of the expanded direct compliance efforts are income tax, sales and use tax, corporate tax, insurance tax, gambling tax and withholding tax. Initiative funding will be used to strategically improve compliance and identify noncompliant taxpayers and resolve noncompliant cases.

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 are tracked as a performance measure for this initiative.

For individual income tax, there have been 7,937 noncompliant taxpayer cases resolved as a result of the tax compliance initiative. 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.

There has been a total of 420 businesses and 435 corporations that have been identified as noncompliant with the sales and use and corporate tax laws. Different from income tax, a business or corporation is noncompliant with the tax laws if the audit or other compliance actions result in a change in taxpayer liability.

Revenues

Additional revenue is generated from these stepped-up compliance actions. Through the end of December 2005 (with 25 percent of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is $17.1 million. Table 2.2 provides detailed data related to the total revenues collected for each tax type/function from this initiative. By the end of FY 2006, the department expects to achieve the legislated goal.

Table 2.2
Biennium Year-To-Date Compliance Initiative Revenue Results

Tax Type/Function	Actual Compliance Collections	Biennium Target	% of Target Achieved
Collection	$6,331,128	$41,300,000	15%
Individual Income Tax	$2,684,470	$9,050,000	30%
Withholding	$230,809	$1,200,000	19%
Sales and Use/Corp Taxes	$6,976,898	$35,173,192	20%
Special Taxes	$736,774	$2,200,000	33%
Tax Operations Early Audit[1]	$169,623	$1,728,000	10%
TOTAL	***$17,129,703***	***$90,651,192***	***19%***

III. Observations and Trends

Important trends affecting tax compliance to note:

- Revenue production from compliance efforts is a function of the number of filled positions in the revenue tax specialist (RTS) and revenue collection officer (RCO) classifications. In FY 2005, the turnover rate or the rate of new hires to resignations for the RTS classification series was 35 percent. The department continues to identify and implement strategies aimed at minimizing the turnover rate for this position classification. For the first half of FY 2006, the turnover rate has slightly declined to 26 percent. This is what the department has done over the last 12 months to decrease turnover for this classification:
    - In consultation with the Department of Employee Relations (DOER), the starting salary for all RTS employees hired since January 2003 has been adjusted. This has resulted in retroactive pay adjustments for approximately 110 RTS employees

[1] In Table 2.3, 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 2006-07 biennium.

- The starting pay for new RTS employees has been adjusted to be more competitive with other employers.
- Improved rewards, recognition and tuition reimbursement policies for all employees.

- The department initiated a data warehouse project in November 2003. The objectives of this project are to reduce redundant data storage, increase compliance opportunities and enable increased efficiency throughout the department. Two of the project's three phases of this project have been compiled. This data warehouse project will directly impact the tax compliance initiatives by improving business intelligence. Improved business intelligence will enable the department to more effectively identify more productive audit selection and collection opportunities.

IV. Appendix – Methodology

Table 1.0

a. Expenditures:

The base for compliance activity expenditures in FY 2004 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 2004 and divided by 2,096.

b. Revenues:

Collections:
The base consists of total collections as reported in the Lotus Notes database called CD FY04 performance. The total revenue production is the sum of collections from tax debt and nontax debt, 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 2001 to FY 2004. 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 is 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 three fiscal years, FY 2002 to FY 2004. 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 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 ten-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 nonfiler 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.

Tax Operations:
The estimate is based on calendar year 2004 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.