MINNESOTA · REVENUE

# Expanded Tax Compliance Initiatives

## Fiscal years 2006 – 2007

## Report to the Minnesota Legislature

January 2007

MINNESOTA · REVENUE

January 10, 2007

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 2006–2007 biennium to generate an added $90.7 million in revenue through stepped up tax enforcement activities. This is the second 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, section 15, subdivisions 2 and 3.

As of November 30, 2006 the Department has spent approximately $9.6 million of the $17.8 million appropriated. This expenditure has led to the collection of $74.6 million, or 82 percent of anticipated $90.7 million for the biennium.

Of the $74.6 million collected,

- $38.4 million was generated from identifying non-filers 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.
- $36.2 million was produced from increases in delinquent tax collection activities.

Based on the results to date, the Department expects to exceed the forecast of $90.7 million in added revenue for the biennium. The Department is generating about $8 in added revenue for every $1 spent on these expanded tax enforcement activities.

Increasing tax audit and enforcement activities is an effective tool in improving tax compliance. But to significantly improve tax compliance requires multiple strategies beyond stepped-up tax enforcement activities. These include getting better data, simplifying tax laws, providing quality service, improving enforcement tools, creating better forms of information reporting and making better use of technology tools over an extended period of time.

The activities described in this report are a part of the Department's on-going effort to identify and address patterns of non-compliance 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,

Ward Einess
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 2006-2007 biennium to collect $90.7 million through expanded tax compliance activities (Laws of Minnesota 2005, Chapter 156, article 1, section 15, subdivision 2-3). This report summarizes the results the department has achieved through the end of November 2006, 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 $74.6 million, or 82 percent, of the anticipated $90.7 million sought through the tax compliance initiatives;

- resolved a total of 20,024 non-compliant individual income tax cases;

- identified a total of 2,044 non-compliant sales and use tax payers and 1,011 non-compliant corporate tax payers; and

- spent $9.6 million and of the total $17.8 million appropriated.

To collect the $74.6 million to date, the Department has spent $9.6 million, or approximately $1 for every $8 collected. In the remaining months of the FY 2006-2007 biennium, the Department expects to exceed the amount forecasted for the initiatives.

## 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, section 15, subdivision 2-3). Copies of this report are available on the Department of Revenue website at www.taxes.state.mn.us.

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## Purpose of this Report

This is the second of two reports by the Department for the FY 2006-2007 biennium. It provides performance results in accordance with the legislation enacted in the 2005 session.

For the FY 2006-2007 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 legislation passed in the 2005 session mandates that the Department reports the following performance results:

- 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, 2004.

This report provides background and a description of the current performance of the expanded tax compliance initiatives within the Department. Biennium-to-date results referenced in this report reflect the time period of July 2005 to November 2006.

This report is organized into four sections:

I. FY 2005 Compliance and Enforcement Base Performance

II. FY 2006-2007 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 2005 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 achieve this goal, 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.

Increasing audits on both individuals and businesses is an effective tool in closing the tax gap. But audits alone will not shrink the tax gap significantly. Closing the tax gap requires a more comprehensive strategy. According to the federal General Accountability Office (GAO), these strategies will include getting better data on the extent of and reasons for non-compliance, simplifying tax laws, providing quality service to taxpayers, enhancing enforcement of tax laws, improving enforcement tools, creating better forms of information reporting and making better use of technology tools.

In Table 1.0, the Department provides an estimate of dollars spent and revenues generated from audit and compliance activities conducted in FY 2005. 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 2005 Estimated Direct Compliance and Enforcement Activity Base Revenue**

| **Tax Type/Function** | FTE | Estimated Compliance Revenues | Estimated Expenditures | Ratio (rev:exp) |
|---|---|---|---|---|
| Collection | 218.6 | $ 205,876,721 | $13,357,133 | 15.4 |
| Individual Income Tax | 118.5 | 21,149,111 | 6,729,370 | 3.1 |
| Withholding | 12.2 | 2,368,397 | 592,032 | 4.0 |
| Sales and Use/Corp Taxes | 192.0 | 117,601,975 | 12,631,805 | 9.3 |
| Special Taxes | 36.0 | 6,859,959 | 2,195,597 | 3.1 |
| Tax Operations | 31.1 | 20,735,963 | 1,625,039 | 12.8 |
| ***TOTAL*** | ***608.4*** | ***$374,592,126*** | ***$37,130,976*** | ***10.1*** |

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 application tools deployed by the Department for audit selection. The ratio of revenues to expenditures continues to remain high, despite 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 November 30, 2006, the Department has spent approximately $9.6 million on this initiative for the FY 2006-2007 biennium. Payroll is the largest expenditure category accounting for 89 percent of total expenditures. Table 2.0 shows these expenditures in detail.

**Table 2.0.**
**FY 2006-07 Expanded Tax Compliance Expenditures through 11/30/06**

| | Expenditures | % of Total |
|---|---|---|
| Payroll | $8,541,605 | 88.58% |
| Contractual | 366,357 | 3.80% |
| Equipment | 116,407 | 1.21% |
| Supplies | 19,374 | .20% |
| Travel | 219,388 | 2.26% |
| Other | 382,128 | 3.95% |
| ***Total*** | ***$9,645,259*** | ***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 134 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 Actual** | **FY 2007 YTD Actual** |
|---|---|---|
| Initiative FTEs | 104 | 134 |

**Noncompliant Taxpayers and Non-compliance Cases**

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 is used to strategically improve compliance and identify non-compliant taxpayers and resolve non-compliant cases.

The number of individual income tax non-compliant 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 20,024 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 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; or
- The auditor files a return for a nonfiling taxpayer.

There has been a total of 2,044 businesses and 1,011 corporations that have been identified as non-compliant with the sales and use and corporate tax laws. Different from income tax, a business or corporation is non-compliant 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 November 2006 (with 71 percent of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is $74.6 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 2007, the Department expects to exceed the amount anticipated for the biennium.

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

| Tax Type/Function | Actual Compliance Collections | Biennium Target | % of Target Achieved |
|---|---|---|---|
| Collection | $36,258,858 | $41,300,000 | 88% |
| Individual Income Tax | 9,178,561 | 9,050,000 | 101% |
| Withholding | 685,834 | 1,200,000 | 57% |
| Sales and Use/Corp Taxes | 25,192,277 | 35,173,192 | 72% |
| Special Taxes | 2,163,377 | 2,200,000 | 98% |
| Tax Operations Early Audit | 1,145,047 | 1,728,000 | 66% |
| ***TOTAL*** | ***$74,623,954*** | ***$90,651,192*** | ***82%*** |

## 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. For FY 2006, the turnover rate was 34 percent. The Department continues to identify and implement strategies aimed at minimizing the turnover rate for the RTS classification. More specifically over the past year the Department has::
    - in consultation with the Department of Employee Relations (DOER), adjusted the starting salary for all RTS employees hired since January. This has resulted in retroactive pay adjustments for approximately 110 RTS employees;
    - improved rewards, recognition and tuition reimbursement policies for all employees; and
    - modified the starting pay for new RTS employees has been adjusted to be more competitive with other employers.

- The Department has continued its data warehouse efforts. The objectives of the data warehouse project are to reduce redundant data storage, increase compliance opportunities and enable increased efficiency throughout the department. The Department has redesigned and migrated all of its legacy warehouse data onto a common database platform, added eleven new data sources and piloted the use of data mining techniques with the assistance of the University of Minnesota. 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 and collection opportunities.

- The Department is currently seeking funding for the development of an integrated tax system which will increase the effectiveness of its compliance programs. An integrated tax system is a software product that supports all tax processing, enforcement and reporting functions performed by a tax agency. It consolidates taxpayer demographics and business registration, tax return and payment processing, accounting, auditing, delinquent tax collection and reporting functions of the 28 tax types administered by the department into a single system. Such a system provides many benefits, such as:

    - accurate, timely information from a single, unified system;
    - enhanced capability to detect non-compliance;
    - significant revenue increases and operational savings (based on other states' experience);
    - direct access for taxpayers to their tax account information and other enhanced services to taxpayer;
    - substantial mitigation of risk of failure; and
    - high-quality, consistent and comparable data.

- Non-compliant taxpayers with debts owed continue to become savvier in hiding assets and evading compliance. This requires the Collection Division to focus more time on researching information to locate debtors and find assets.

- While most taxpayers voluntarily pay their tax, some refuse to pay their tax under any circumstance, which results in the Collection Division having to do more enforced collection actions.

- A growing number of sales are being made over the internet where the seller is not required to charge taxes because the seller does not have a presence in Minnesota. This change in individual and business purchasing behavior creates an un-level playing field for main street businesses, reduces sales tax revenues and increases the use tax gap for all states. According to the Department of Revenue report, *Minnesota Sales and Use Tax Gap: Final Report*, November 19, 2002, prepared by American Economics Group, Inc., total sales and use tax loss from commerce and catalog sales in 2002 was $170.3 million. This was projected to grow to $291.7 million by 2006.

  Since 2000, Minnesota has been working with more than 40 states to develop a simplified and more uniform sales tax system for all businesses with the hope that the U.S. Congress will require remote sellers to collect the sales tax for any state that adopts the conforming features of the Streamlined Sales Tax Agreement. Minnesota has already adopted these provisions and is a full member of the national Streamlined Sales Tax Governing Board. As more provisions are adopted, Minnesota will need to adopt them as well.

- The Department is serving a more linguistic and culturally diverse population. To improve compliance among non-English speakers, the agency must expand its services beyond the specialized outreach programs it now offers.

- More businesses and individuals are challenging state tax laws. This is evidenced by more appeals, more litigation and a longer period of time in which tax disputes are resolved and paid.

## IV. Appendix – Methodology

Table 1.0

**Expenditures:**

The base for compliance activity expenditures in FY 2005 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 2005 and divided by 2,096.

**Revenues:**

**Collections:**
The base consists of total collections as reported in the Lotus Notes database called CD FY05 performance. The total revenue production is the sum of collections from tax debt and non-tax 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 2002 to FY 2005. 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 were 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 2003 to FY 2005. 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 2002 to FY 2004. Included in this estimate are the following compliance activities:
- Dollars collected from payments received within 95 days of the order date 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 taconite production 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 2005 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.