

MINNESOTA • REVENUE

Expanded Tax Compliance Initiatives

Fiscal Year 2009

Report to the Minnesota
Legislature

January 2010

January 11, 2010

To the members of the legislature of the State of Minnesota:

The Minnesota Legislature appropriated \$7 million to the Department of Revenue in fiscal year 2009 to generate an added \$21 million in revenue through stepped-up tax enforcement activities. This is the second of two reports on progress toward achieving this goal.

The appropriation for increased tax compliance activities was authorized by the legislature under Laws of Minnesota 2008, Chapter 363, Article 13, Section 012, subdivisions 000.

As of June 30, 2009, the Department spent \$6.8 million of the \$7 million appropriated. This expenditure has led to the collection of \$29.8 million, or 142 percent of anticipated \$21 million for the fiscal year.

Of the \$29.8 million collected,

- \$19.7 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.
- \$10.1 million resulted from an increase in delinquent tax collection activities.

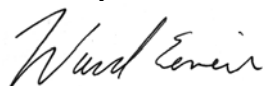
Based on the results, the Department generated about \$4.4 in added revenue for every \$1 spent on the expanded tax enforcement activities.

Increasing tax audit and enforcement activities is an effective tool in improving tax compliance. However, to significantly improve and sustain tax compliance requires multiple strategies beyond stepped-up tax enforcement activities. These include obtaining better data, simplifying tax laws, providing quality service, improving enforcement tools, creating better forms of information reporting and improved use of technology tools over an extended period of time. The Department is committed to pursuing these strategies.

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,



Ward Einess
Commissioner

**Laws of Minnesota 2008, Chapter 363, Article 13, Section 012,
Subdivision 000.**

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Summary of Findings

The Minnesota Legislature appropriated \$7 million to the Department of Revenue for fiscal year 2009 to collect \$21 million through expanded tax compliance activities (Laws of Minnesota 2008, Chapter 363, Article 13, Section 012, Subdivision 000). This report summarizes the results the department has achieved through the end of June 2009, and is the second of two reports. During this period — with 100 percent of the fiscal year completed — the Department has:

- Collected and deposited in the general fund \$29.8 million, or 142 percent, of the anticipated \$21 million sought through the tax compliance initiatives;
- Resolved a total of 8,186 non-compliant individual income tax cases;
- Identified a total of 1043 non-compliant sales and use tax payers and 422 non-compliant corporate tax payers; and
- Expended \$6.8 million of the total \$7 million appropriated.

To collect the \$29.8 million to date, the Department has spent \$6.8 million, or approximately \$1 for every \$4.4 collected.

Expanded Tax Compliance Initiatives Report

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 2008, chapter 363, article 13, section 012, subdivision 000). Copies of this report are available on the Department of Revenue website at www.taxes.state.mn.us.

Cost of report preparation: \$28 x 20 hours = \$560

Report printing cost: \$55

Total estimated cost of this report: \$615

Purpose of this Report

This is the second of two reports by the Department for fiscal year 2009. It provides performance results in accordance with the legislation enacted in the 2008 session.

For fiscal year 2009, the Department was appropriated \$7 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 \$21 million by the end of FY 2009. These new revenues were included in the current forecast for the FY2008-2009 biennium.

The legislation passed in the 2008 session mandates that the Department report the following performance results:

- the number of corporations noncompliant with the corporate tax system each year and the percentage and dollar amounts of valid tax liabilities collected;
- the number of businesses noncompliant with the sales and use tax system and the percentage and dollar amount of the valid tax liabilities collected;
- the number of individual noncompliant cases resolved and the percentage and dollar amount of valid tax liabilities collected;
- identify base level expenditures and staff positions related to compliance and audit activities, including baseline information as of January 1, 2006. This information must be provided at the budget activity level.

This report provides background and a description of the current performance of the expanded tax compliance initiatives within the Department. Fiscal year-to-date results referenced in this report reflect the time period of July 1, 2008 thru June 30, 2009.

This report is organized into four sections:

- I. FY 2008 Compliance and Enforcement Base Performance
- II. FY 2009 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 2008 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 of 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 more comprehensive strategies. According to the federal General Accountability Office (GAO), these strategies 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 2008. For the tax types listed in table 1.0, estimated compliance revenues are “assessments” based on audits. Taxpayers have 90 days to appeal assessments before they are sent to the Collection Division for enforced compliance. The Appendix (page 9-10) describes the methodology for Table 1.0.

Table 1.0
FY 2008 Estimated Direct Compliance and Enforcement Activity Base Revenue

Tax Type/Function	FTE	Estimated Compliance Revenues	Expenditures	Ratio (rev:exp)
Collection	263.1	\$ 247,371,959	\$ 15,958,357	15.5
Individual Income Tax	108.0	23,717,905	6,648,474	3.7
Withholding	16.2	1,152,768	998,013	1.3
Sales and Use Taxes	201.3	107,765,476	14,030,456	7.7
Corp Taxes	94.9	68,710,343	6,618,014	10.8
Special Taxes	56.8	27,422,316	3,926,164	7.6
Tax Operations	<u>37.4</u>	<u>20,840,344</u>	<u>2,200,176</u>	<u>9.5</u>
TOTAL	777.7	\$ 496,981,111	\$ 50,379,654	9.9

The base revenues generated from all audit and compliance activities is a function of multiple variables such as the retention of experienced auditors and collectors, as well as the quality 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 2009 Expanded Tax Compliance Initiative

Expenditures and Full-time Equivalents

As of June 30, 2009, the Department has spent approximately \$6.8 million on this initiative for Fiscal Year 2009. Payroll is the largest expenditure category accounting for 66.1% of total expenditures. Table 2.0 displays expenditure detail.

Table 2.0.
FY 2009 Expanded Tax Compliance Expenditures through 6/30/09

	Expenditures	% of Total
Payroll	\$4,494,082	66.1%
Contractual	1,105,000	16.3%
Equipment	444,557	6.5%
Supplies	39,192	0.6%
Travel	71,674	1.0%
Other	<u>646,024</u>	<u>9.5%</u>
Total	\$6,800,529	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 2008, approximately 79.7 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 2009 YTD Actual	FY 2009 Planned
Initiative FTEs	79.7	76

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 other special taxes. 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 8,186 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 (“commissioner-filed” return).

There have been a total of 1043 businesses and 422 corporations that have been identified as non-compliant with the sales and use and corporate tax laws. In contrast to the individual 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 June 2009 (with 100 percent of the fiscal year completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is \$29.8 million.

Table 2.2 provides detailed data related to the total revenues collected for each tax type/function from this initiative.

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

Tax Type/Function	Actual Compliance Collections	FY 2009 Target	% of Target Achieved
Collection	\$10,123,033	\$7,004,000	145%
Individual Income Tax	3,226,461	3,003,000	107%
Sales & Use Tax	8,900,363	4,608,000	193%
Corp Taxes	4,413,848	4,200,000	105%
Special Taxes	2,217,908	985,000	225%
Withholding	<u>920,937</u>	<u>1,200,000</u>	<u>77%</u>
TOTAL	\$29,806,508	\$21,000,000	142%

III. Observations and Trends Affecting Tax Compliance

Important trends affecting tax compliance:

- **Audit Turnover Rates**-- 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 2007, the turnover rate (the rate of new hires to resignations for the RTS classification series) was 40.3 percent. For FY 2008, the turnover rate was 39.6 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:
 - improved rewards and recognition for all employees; and
 - modified the starting pay for new RTS employees to be more competitive with other employers.
- **Data Warehouse and Mining**-- 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 seventeen 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.

- **Installation of Modern, Integrated Tax Processing System**-- The Department received \$12 million from the 2007 Legislative session for the development of an integrated tax system, the department's top technology project for the 2008/2009 biennium. This is a substantial down payment for the project- enough to start it with reasonable assurance that future implementation and ongoing license and maintenance costs will be provided by future legislatures.
 - Late in 2007 FAST Enterprises was selected for the project. Major factors in the selection of FAST included its singular focus on helping revenue agencies implement new tax-administration systems, its flawless record of on-time and within-budget installations and the fact that its tax-processing software, called "GenTax" is a true off-the-shelf product.
 - When the project is complete the department will be able to provide better service to taxpayers because the common processes and interfaces of the integrated system will generate more consistent and more accurate tax and accounting data, and our answers to taxpayer questions will come more quickly and be more accurate because we will not have to go into and out of various systems to find them.

- **Research**-- 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.

- **Enforcement**-- 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.

- **Implications of U.S. Supreme Court (*Quill*)**-- A growing number of sales are being made over the internet where sellers are not required to charge taxes due to a U.S. Supreme Court decision prohibiting states from collecting sales taxes from sellers who do not have a physical presence within the state. This prohibition creates an uneven playing field for in-state "brick and mortar" businesses relative to Internet retailers and increases the state's use tax gap. The Department of Revenue estimates that the tax gap attributed to *retail* e-commerce and catalog sales was \$151 million in 2008 (rising to \$205 million in 2011). If *wholesale-level* remote sales to businesses are also included, the estimated gap for 2008 totals \$325 million -- over half of the total sale and use tax gap -- and is projected to rise to almost \$400 million in 2011.

- **Working to Overcome *Quill***-- Since 2005, Minnesota has been a full member of the national Streamlined Sales Tax Governing Board, along with 22 other states. This Board is a multi-state organization formed to administer the "Streamlined Sales Tax Agreement", which provides for simplification and uniformity for all businesses required to collect sales and use taxes. It is hoped that simplified administration and uniformity features in the Agreement will encourage the U.S. Congress to require remoter sellers to collect the sales tax for any state that adopts the conforming features of the Agreement.

- **Growing Diversity**-- 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.
- **Increasing Challenges to State Tax Laws**-- More taxpayers 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 2008 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 dividing the total number of hours worked in FY 2008 by 2,088, the number of work hours in a year.

Revenues:

Collections:

The base consists of total collections as reported in the Collections Division monthly performance spreadsheet. 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 2005 to FY 2008. 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.
- Dollars denied on claims for refund. It is assumed that 100 percent is collected on denied claims amounts.

Corporate Tax:

The estimate for base collections is derived from a rolling average of three fiscal years, FY 2006 to FY 2008. 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 2005 to FY 2007. 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: petroleum, 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 fiscal year 2008 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.