

Special Review

---

# **Department of Revenue**

## **Non-filer and Tax Compliance Initiatives**



---

---

## Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota State government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately fifty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year and one best practices review.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of Representatives and Senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

---

This document can be made available in alternative formats, such as large print, Braille, or audio tape, by calling 651-296-1727 (voice), or the Minnesota Relay Service at 651-297-5353 or 1-800-627-3529.

All OLA reports are available at our Web Site: <http://www.auditor.leg.state.mn.us>

If you have comments about our work, or you want to suggest an audit, investigation, evaluation, or best practices review, please contact us at 651-296-4708 or by e-mail at [auditor@state.mn.us](mailto:auditor@state.mn.us)



**OFFICE OF THE LEGISLATIVE AUDITOR**  
State of Minnesota • James Nobles, Legislative Auditor

Senator Ann H. Rest, Chair  
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Dan Salomone, Commissioner  
Department of Revenue

We have completed a special review of the non-filer and tax compliance initiatives of the Minnesota Department of Revenue for the period July 1, 2001, through November 30, 2002. The primary objective of our review was to compare the actual revenue collections as a result of the initiatives to the estimates of new revenue submitted by the department to the Legislature. Another objective was to determine whether the department spent funds from the tax initiative appropriations only for costs related to the tax initiative projects.

This report is submitted to the Legislature pursuant to Laws of Minnesota 2001, First Special Session, Chapter 10, Article 1, Section 16 and Laws of Minnesota 2002, Chapter 377, Article 12, Section 17.

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Revenue. This restriction is not intended to limit the distribution of this report, which was released as a public document on January 30, 2003.

*/s/ James R. Nobles*

James R. Nobles  
Legislative Auditor

*/s/ Claudia J. Gudvangen*

Claudia J. Gudvangen, CPA  
Deputy Legislative Auditor

End of Fieldwork: January 15, 2003

Report Signed On: January 27, 2003

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

---

**Table of Contents**

---

	Page
Report Summary	1
Chapter 1. Introduction	3
Chapter 2. Tax Initiative Revenues	5
Chapter 3. Tax Initiative Expenditures	9

**Audit Participation**

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
David Poliseno, CPA, CISA	Audit Manager
Tony Toscano	Auditor-in-Charge
Marisa Isenberg	Auditor

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

---

**Report Summary**

---

*Overall Conclusions*

*The Department of Revenue accurately reported the amounts collected as a result of the non-filer and the two tax compliance initiatives. In its January 15, 2003, report to the Legislature, the department reported that, as of November 30, 2002, it had collected \$57.3 million for the three initiatives. The department has met the \$52 million target for the non-filer and first tax compliance initiative and appears on track to meet the \$7.6 million target for the second tax compliance initiative by June 30, 2003. During our testing of initiative transactions, we identified two cases where the department recorded an incorrect amount of revenue for the initiative. The department corrected the errors and included the proper amounts in its report to the Legislature. Based on our review of the department's control procedures, we think these were isolated errors.*

*As of November 30, 2002, the Department of Revenue had spent about \$5.3 million on the non-filer and tax compliance initiatives. In general, the department accurately reported initiative expenditures in the accounting records and processed the expenditures in compliance with applicable legal provisions and management's authorization. However, we noted two instances where costs related to the initiative programs were not properly charged to the special appropriations. The department intends to process expenditure transfer transactions to properly record costs related to the initiatives.*

---

**Background Information**

Laws of Minnesota 2001, First Special Session, Chapter 10, Article 1, Section 16 appropriated \$7.672 million to the Department of Revenue to fund new non-filer and tax compliance initiatives. This law also established the amount of additional tax revenue the department was expected to collect under each initiative. For the 2002-2003 biennium, the law set target amounts of \$20 million for the non-filer initiative and \$32 million for the tax compliance initiative. Laws of Minnesota 2002, Chapter 377, Article 12, Section 17 appropriated \$7.6 million for a third initiative. This initiative was an effort by the department to restore about \$5 million in previous budget cuts in tax compliance areas and to provide an additional \$2.6 million in funding for new compliance efforts. This law anticipated that the department would generate at least \$7.6 million in additional General Fund revenue during the 2002-2003 biennium as a result of the appropriation.

Pursuant to the previously cited 2001 and 2002 appropriation laws, the objective of this special review was to compare actual revenue collections with the estimates of new revenue collections submitted by the Department of Revenue to the Legislature.

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

*This page intentionally left blank.*

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

---

**Chapter 1. Introduction**

---

The Department of Revenue is responsible for managing the state's tax systems. The department collects approximately \$13 billion per year from various tax programs including individual income, sales, corporate franchise, petroleum, insurance, health care, alcohol, property, and cigarette and tobacco taxes. Minnesota relies on its citizens' voluntary compliance with tax laws.

The overall mission of the department is to make the revenue system work well for Minnesotans. The department works to promote compliance through several different efforts, including developing sound tax policies, educating citizens, providing expedient customer service, and providing administrative and enforcement services in the area of tax assessment collections. In an effort to further its mission, in 2001, the department requested and received funding for two tax initiatives. The focus of the non-filer and tax compliance initiatives was on taxpayers that do not voluntarily file tax returns, pay taxes due, or otherwise comply with the tax laws.

Laws of Minnesota 2001, First Special Session, Chapter 10, Article 1, Section 16 appropriated a total of \$7.672 million to fund these two initiatives for the 2002-2003 biennium. This law also established the amount of tax revenue the department was expected to collect during the biennium for each initiative. The law set target amounts at \$20 million for the non-filer initiative and \$32 million for the tax compliance initiative.

Laws of Minnesota 2002, Chapter 377, Article 12, Section 17 appropriated an additional \$7.6 million for a third initiative. The department used this funding, in part, to offset previous budget cuts in the tax audit and compliance areas. The 2002 legislation anticipated that the department would collect an additional \$7.6 million in General Fund revenue for the 2002-2003 biennium.

Chapter 2 of this report provides our conclusions on the actual tax initiative revenues collected by the Department of Revenue as of November 30, 2002. Chapter 3 provides our conclusions on the department's use of appropriations dedicated to the initiative programs.

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

*This page intentionally left blank.*

---

## Chapter 2. Tax Initiative Revenues

---

### *Chapter Conclusions*

*The Department of Revenue accurately reported the amounts collected as a result of the non-filer and the two tax compliance initiatives. In its January 15, 2003, report to the Legislature, the department reported that, as of November 30, 2002, it had collected \$57.3 million for the three initiatives. The department has met the \$52 million target for the non-filer and first tax compliance initiative and appears on track to meet the \$7.6 million target for the second tax compliance initiative by June 30, 2003. During our testing of initiative transactions, we identified two cases where the department recorded an incorrect amount of revenue for the initiative. The department corrected the errors and included the proper amounts in its report to the Legislature. Based on our review of the department's control procedures, we think these were isolated errors.*

---

The Legislature funded three tax initiatives for the 2002-2003 biennium. The three initiatives, referred to as non-filer, tax compliance, and tax compliance II, were funded in an effort to increase the level of compliance with the state's tax laws. Several divisions within the Department of Revenue worked on the initiatives, including individual income tax, corporate franchise tax, sales and use tax, special taxes, and the Minnesota Collection Enterprise. The department identified revenue collections relating to the initiatives by segregating and tracking the tax assessments issued by the employees working on the initiatives.

### **Non-filer Initiative**

The purpose of the non-filer initiative was to identify and collect tax liabilities from individuals and businesses that currently do not pay all taxes owed. A non-filer is a taxpayer that does not file the appropriate forms or report their tax liability within the legal time limit. Non-filing businesses and corporations include out-of-state businesses and corporations that have a presence in Minnesota, but do not file returns or pay taxes owed.

The department used several methods to locate non-filers, including:

- review of data provided by the Internal Revenue Service;
- verification of income reported by Minnesota taxpayers on their federal tax returns;
- data exchanges with other state agencies; and
- review of newspapers, periodicals, websites, and annual reports to identify unreported business activity.

## Department of Revenue

### Special Review: Non-filer and Tax Compliance Initiatives

In addition, as part of the non-filer initiative, the department took advantage of the federal offset program in an attempt to recapture Minnesota state tax debt by offsetting federal tax refunds. The program is similar to the state's revenue recapture program. The Department of Revenue refers tax debt cases to the federal government. If the case meets the federal offset criteria, the program will capture any federal refunds due to the taxpayer (up to the amount of state tax owed) and remit that amount to the state.

Table 2-1 shows the actual non-filer tax collections through November 30, 2002, and the department's targeted collection amounts for the biennium ending June 30, 2003.

---



---

**Table 2-1**  
**Non-filer Collections**  
**July 1, 2001 – November 30, 2002**

Tax Type	Amount Collected	Target Amounts
Minnesota Collection Enterprise	\$ 9,282,629	\$ 7,000,000
Sales and Use Tax	2,820,955	5,090,000
Corporate Tax	2,576,158	4,580,000
Federal Offset Collections	<u>2,539,096</u>	<u>3,400,000</u>
<b>Total Amount Collected</b>	<b><u>\$17,218,838</u></b>	<b><u>\$20,070,000</u></b>

Note: Actual target amount established in law was \$20,000,000.

Source: January 2003 Non-filer and Tax Compliance Initiatives for FY 2002-2003 Report to the Minnesota Legislature, auditor verification to supporting documentation.

---

### Tax Compliance Initiative

The purpose of the first tax compliance initiative was to increase audit and collection activity in the income tax, sales tax, and corporate tax areas. The department focuses on those taxpayers it thinks are furthest from compliance with tax laws. The department uses the following audit and collection methods as part of its tax compliance strategy:

- conducting partial audits in specific areas where non-compliance has been identified,
- targeting audits to types of businesses with a history of non-compliance, and
- written notices, seizures of real and personal property, and levies on financial assets of non-compliant taxpayers.

Table 2-2 shows the actual collections through November 30, 2002, and the department's targeted collections for the biennium ending June 30, 2003, for the first tax compliance initiative.

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

**Table 2-2**  
**Tax Compliance Collections**  
**July 1, 2001 – November 30, 2002**

<b>Tax Type</b>	<b>Amount Collected</b>	<b>Target Amounts</b>
Minnesota Collection Enterprise	\$24,174,635	\$23,000,000
Corporate Tax	7,926,924	3,225,000
Sales and Use Tax	3,713,215	4,850,000
Individual Income Tax	<u>520,905</u>	<u>1,328,000</u>
<b>Total</b>	<b><u>\$36,335,679</u></b>	<b><u>\$32,403,000</u></b>

Note: Actual target amount established in law was \$32,000,000.

Source: January 2003 Non-filer and Tax Compliance Initiatives for FY 2002-2003 Report to the Minnesota Legislature, auditor verification to supporting documentation.

**Tax Compliance II**

The second tax compliance initiative also focused on identifying and collecting tax liabilities from individuals and businesses that currently do not pay all taxes owed. In addition to increasing audit and collection activities in the income, sales, and corporate tax areas, the appropriation law identified lawful gambling and insurance taxes as areas of emphasis. As a result, through this new initiative, the department expanded its efforts to include the special taxes division. Also, in September 2002, the department began receiving data from the federal government identifying income reported by non-residents for partnerships and S-Corporations with a Minnesota address. The department compared those amounts to the amounts reported by the taxpayers on their Minnesota tax returns to ensure that the taxpayer paid the correct amount of tax to Minnesota.

Table 2-3 shows the actual and targeted collections for this tax compliance II initiative, which began on July 1, 2002.

**Table 2-3**  
**Tax Compliance II Collections**  
**July 1, 2002 – November 30, 2002**

<b>Tax Type</b>	<b>Amount Collected</b>	<b>Target Amounts</b>
Minnesota Collection Enterprise	\$2,579,644	\$3,500,000
Corporate Tax	675,038	942,000
Sales and Use Tax	320,240	1,045,000
Special Taxes	184,019	450,000
Individual Income Tax	<u>25,595</u>	<u>1,700,000</u>
<b>Total</b>	<b><u>\$3,784,536</u></b>	<b><u>\$7,637,000</u></b>

Note: Actual target amount established in law was \$7,600,000.

Source: January 2003 Non-filer and Tax Compliance Initiatives for FY 2002-2003 Report to the Minnesota Legislature, auditor verification to supporting documentation.

# **Department of Revenue**

## **Special Review: Non-filer and Tax Compliance Initiatives**

### **Audit Objectives and Methodology**

Our review of collections related to the three initiatives focused on the following questions:

- Did the Department of Revenue accurately report tax collections directly related to the tax initiatives?
- For the biennium ending June 30, 2003, will the Department of Revenue generate actual collections of at least \$52 million from the non-filer and tax compliance initiatives and at least \$7.6 million from the tax compliance II initiative?

To address these objectives, we interviewed Department of Revenue personnel to gain an understanding of the controls in place over revenue collection. We reviewed the 2002 and 2003 performance reports to the Legislature relating to non-filer and tax compliance initiative activity. We performed analytical reviews of the department's revenue collections. In addition, we tested 132 tax assessments from the tax initiative population to determine if the revenue reported as generated from those assessments related to the tax initiatives.

### **Conclusions**

The Department of Revenue accurately reported the amounts collected as a result of the non-filer and the two tax compliance initiatives. In its January 15, 2003, report to the Legislature, the department reported that, as of November 30, 2002, it had collected \$57.3 million for the three initiatives. The department has met the \$52 million target for the non-filer and first tax compliance initiative and appears on track to meet the \$7.6 million target for the second tax compliance initiative by June 30, 2003. During our testing of initiative transactions, we identified two cases where the department recorded an incorrect amount of revenue for the initiative. The department corrected the errors and included the proper amounts in its report to the Legislature. Based on our review of the department's control procedures, we think these were isolated errors.

---

## Chapter 3. Tax Initiative Expenditures

---

### *Chapter Conclusions*

*As of November 30, 2002, the Department of Revenue had spent about \$5.3 million on the non-filer and tax compliance initiatives. In general, the department accurately reported initiative expenditures in the accounting records and processed the expenditures in compliance with applicable legal provisions and management's authorization. However, we noted two instances where costs related to the initiative programs were not properly charged to the special appropriations. The department intends to process expenditure transfer transactions to properly record costs related to the initiatives.*

---

The Legislature provided separate appropriations for each of the three initiatives undertaken by the Department of Revenue during the 2002-2003 biennium. The 2001 Legislature appropriated a total of approximately \$2.2 million for the non-filer initiative and \$5.5 million for the tax compliance initiative in fiscal years 2002 and 2003. As part of the 2002 budget balancing plan, the Legislature reduced the Department of Revenue's appropriations by \$7 million each year. As a result, the department cut the two tax initiative budgets by a combined \$512,000. During the 2002 legislative session, the Legislature appropriated \$7.6 million to the department to fund the tax compliance II initiative. This initiative was an effort by the department to restore about \$5 million in previous budget cuts in tax compliance areas and to provide an additional \$2.6 million in funding for new compliance efforts.

As of November 30, 2002, the Department of Revenue had spent approximately \$5.3 million on payroll and other administrative expenditures related to the various initiatives. Each tax division managed its own initiative budget and was responsible to ensure that expenditures specifically related to the initiatives. As of November 30, 2002, payroll was the largest expenditure category accounting for approximately 84 percent of the total expenditures. The department reported that it had hired 88.42 FTE staff for work on compliance activities related to the initiatives.

Table 3-1 shows a breakdown of the three appropriations and the recorded expenditures through November 30, 2002.

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

**Table 3-1**  
**Initiative Appropriations and Expenditures**  
**July 1, 2001 – November 30, 2002**

	<b>Non-filer</b>	<b>Tax Compliance</b>	<b>Tax Compliance II</b>	<b>Total</b>
Appropriations <sup>(Note 1)</sup>	\$2,193,000	\$5,479,000	\$2,569,000	\$10,241,000
Less: Budget Cuts	<u>197,000</u>	<u>315,000</u>	<u>0</u>	<u>512,000</u>
Available Resources	<u>\$1,996,000</u>	<u>\$5,164,000</u>	<u>\$2,569,000</u>	<u>\$ 9,729,000</u>
Expenditures:				
Payroll	\$ 938,430	\$3,001,949	\$ 493,955	\$4,434,335
Contractual Services	326,757	0	0	326,757
Equipment	52,275	106,351	34,457	193,083
Supplies	14,024	24,120	9,059	47,203
Other	<u>53,664</u>	<u>169,946</u>	<u>45,408</u>	<u>269,018</u>
Total Expenditures	<u>\$1,385,150</u>	<u>\$3,302,366</u>	<u>\$ 582,879</u>	<u>\$5,270,395</u>
Remaining Balance	<u>\$ 610,850</u>	<u>\$1,861,634</u>	<u>\$1,986,121</u>	<u>\$4,458,605</u>

Note 1: In addition to the \$2,569,000 appropriation allocated to Tax Compliance II for new tax compliance initiatives, the department used approximately \$5,000,000 of its 2002 appropriation to offset previous budget cuts in the compliance area.

Note 2: As of November 30, 2002, the department had encumbrances totaling \$2,964,762 for anticipated expenditures through June 30, 2003.

Source: Minnesota Accounting and Procurement System as of November 30, 2002.

**Audit Objective and Methodology**

The primary objective of our audit of initiative expenditures was to answer the following questions:

- Did the department accurately record payroll and other administrative expenditures in the accounting records?
- Did the department ensure that only expenditures related to the tax initiatives were charged against the initiative appropriations?

To address these questions, we interviewed department staff to gain an understanding of the process for charging expenditures to the initiative appropriations. We also tested a sample of expenditure transactions to determine if the department properly authorized, processed, and recorded the expenditures.

**Department of Revenue**  
**Special Review: Non-filer and Tax Compliance Initiatives**

**Conclusions**

As of November 30, 2002, the Department of Revenue had spent about \$5.3 million on the non-filer and tax compliance initiatives. In general, the department accurately reported initiative expenditures in the accounting records and processed the expenditures in compliance with applicable legal provisions and management's authorization. However, we noted two instances where costs related to the initiative programs were not properly charged to the special appropriations. The department intends to process expenditure transfer transactions to properly record costs related to the initiatives.