

**Non-filer and
Tax Compliance
Initiatives
for FY 2002–2003**

**Report to
the Minnesota
Legislature**

January 2003

MINNESOTA • REVENUE

**This report is prepared in accordance with the
Laws of Minnesota 2001, First Special Session**
Chapter 10, Article 1, Section 16, subdivision 2

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MINNESOTA • REVENUE

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

The Minnesota legislature appropriated about \$10 million to the Department of Revenue in the 2002–03 biennium to generate an added \$60 million general fund revenue through stepped up tax enforcement activities. This is the second of two reports on progress toward achieving this goal.

(These initiatives were authorized by the legislature under Laws of Minnesota 2001, First Special Session, Chapter 10, Article 1, Section 16, subdivision 2 and Laws of Minnesota 2002, Chapter 377, Article 12, section 17.)

To date, the department has spent \$5.3 million of the approximately \$10 million appropriated, and collected \$57.3 million. Based on the results to date, the department fully expects to collect far more than \$60 million by end of 2002-03 biennium.

Of the \$57.3 million collected so far:

- \$17.2 million was generated from identifying nonfilers. (Over 500 individual income tax nonfiler cases have been resolved, and more than 300 new businesses and corporations have been brought into the tax system.)
- \$40.1 million was produced from increases in existing audit and delinquent tax collection activities.

Based on these results, the department estimates that it generates \$10.80 in added revenue for every \$1 spent on expanded tax enforcement activities. Now that the department has made the investments necessary to support these activities, the revenue gains generated from these activities should continue to grow.

The activities described in this report are a part of the department's effort to pursue those who are furthest from compliance with the state's tax laws.

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

Sincerely,

Daniel A. Salomone
Commissioner

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Summary of Findings

This report summarizes FY 2002-03 biennium year-to-date non-filer and tax compliance initiative activity from July 2001 through November 2002. Major performance results achieved during this report period include:

- The total revenue collected from the non-filer and tax compliance initiatives and deposited into the general fund is \$57.3 million. Of that amount, \$17.2 million was from the non-filer initiative and \$40.1 million was from the tax compliance initiatives.
- A total of 70,672 cases have been referred with \$180 million of associated dollars of debt to the Financial Management Services for recapture of Minnesota state taxes. Of the 70,672 cases, so far 5,889 cases were offset and \$2.5 million has been collected from the program and sent to the general fund as a part of the non-filer initiative.
- A total of 561 individual income non-filer cases have been resolved and 309 new business and corporations have been brought into the tax system.

As of November 2002, the department has 88.42 FTE and \$5.3 million has been expended for compliance activities related to the initiatives. By the end of the FY 2002-03 biennium, the department expects to meet or exceed all of the revenue targets established in legislation for the non-filer and tax compliance initiatives.

Estimated Cost of Preparing this Report

Minnesota statute §3.197 requires that a report to the legislature contain the cost of preparing the report. This report provides performance indicators related to the FY 2002-2003 non-filer and tax compliance initiatives. The data needed for this report is collected using ad hoc reporting tools and manual processes from various systems that are part of Minnesota Department of Revenue's (the department's) normal business functions. The cost of this report does not include the cost of gathering the data but rather is limited to the estimated cost of analyzing the data and preparing the document. This cost of preparing the report is estimated at \$1,120.

Purpose of this Report

This is the second report of the department's FY 2002-2003 non-filer and tax compliance initiatives. This report provides mandatory performance indicator results in accordance with Laws of Minnesota 2001, First Special Session, Chapter 10, Article 1, Section 16, Subdivision 2, paragraph C.

For the FY 2002-03 biennium, the department was first appropriated \$7.672 million from the general fund¹: (1) to identify and collect tax liabilities from individuals and businesses that currently do not pay taxes owed; and (2) to increase audit and tax collection activity in the income tax, sales tax and corporate tax areas. The 2002 legislature provided an additional \$2.569 million to augment efforts on these compliance initiatives in the same tax areas, as well as lawful gambling and insurance taxes.

These initiatives are expected to result in new general fund revenues of \$60 million by the end of the FY 2002-03 biennium.²

As required, this report provides biennium year-to-date performance results for the following:

- Base level expenditures and full-time equivalent (FTE)³ information related to the compliance and audit activities, including baseline as of FY 2001.

¹ The 2001 Legislature appropriated \$7.672 million in FY 02-03 for the non-filer and tax compliance initiatives. The FY 2002 appropriation was reduced by \$512,000 as a result of budget cuts.

The 2002 Legislature appropriated \$7.6 million in FY 03 to the department. Of this amount, \$2.569 million was allocated to the tax compliance initiative and the remaining amount to DOR operations for the restoration of base funds for compliance which were reduced by budget cuts. Minnesota Session Laws 2002, Chapter 377, Article 12, section 17, paragraph A.

² According to 2001 and 2002 Minnesota Session Laws, the non-filer, tax compliance and tax compliance II initiatives are expected to result in new general fund revenues of \$20 million, \$32 million and \$7.6 million respectively for the FY 2002-03 biennium.

- The number of debt cases referred each year to Financial Management Services (FMS), a branch of the U.S. Treasury Department, for recapture of Minnesota state taxes from federal tax refunds and the associated dollar amounts.⁴
- The number of non-filing corporations brought into the corporate tax system each year and the dollar amounts of valid tax liabilities collected.
- The number of non-filing businesses brought into the sales and use tax system and the dollar amounts of valid tax liabilities collected.
- The number of individual income tax non-filer cases resolved and the dollar amounts of valid tax liabilities collected.

The department is being held accountable for these results. If the Office of the Legislative Auditor determines that the results for each initiative will be not achieved in the FY 2002-03 biennium, the commissioner of finance must cancel from the budget reserve account to the general fund the difference between the expected revenues and the actual revenues.

Background

The revenue system is made up of several state taxes, a state general fund levy property tax and the local property tax collected by county governments. State taxes include individual income, sales, corporate franchise, petroleum, environmental, gambling, cigarette and tobacco, alcohol, and insurance. The department collects approximately \$13 billion per year of state taxes.

The overall mission of the department is to make the revenue system work well for Minnesotans. In an effort to further this mission, the department received funding for two initiatives during the FY 02-03 biennium to increase the level of compliance with tax laws. Although the vast majority of the taxpayers voluntarily comply with the tax laws, the focus of the non-filer and tax compliance initiatives is on taxpayers that do not voluntarily file, pay or comply with the tax laws. It is expected that these initiatives will have several positive outcomes such as a fairer tax system and increased revenue. As required, the department will be tracking the latter in this report.

³ Minnesota statute § 16A.22 defines a full-time equivalent (FTE) position as 2080 working hours per year; except that number of work hours may vary depending on the exact number of working days in any given year.

⁴ The Financial Management Service, not the Internal Revenue Service (IRS), runs the federal offset program.

Compliance and Audit Activities Base Line Information

The type of compliance and audit activities required to pursue non compliant taxpayers include, but are not limited to: (1) audits of taxpayer filings to correct errors and detect abuse; and (2) identifying non-filers and unreported taxable activity. These activities directly relate to one of the department's strategic goals, which is to focus on taxpayers that are furthest from compliance.

As first reported in the January 2002 report on non-filer and tax compliance initiatives, the department has estimated base line information for its compliance and audit activities. The base-line information reported in Table 1 may be used as a point of reference from which to monitor change. The overall ratio of collections to expenditures for these compliance areas is 11.6 in FY 2001. Except for the Minnesota Collection Enterprise, baseline collections have been estimated using a three-year average of collections for sales and use tax, corporate tax and individual income tax. These computations required the utilization of ad hoc reports and manual processes because the department is without a universal business system to report collections for each tax type.

Table 1.

FY 2001 Base Line Data

Tax Type/Division	FTE ⁵	Expenditures ⁶	Estimated Collections ⁷	Ratio (Coll:Exp)
Sales & Use/Corporate Taxes	132	\$8,397,029	\$55,464,174	6.6
Individual Income Tax (IT)	47	\$2,585,000	\$ 8,062,304	3.1
MCE	143	\$7,630,860	\$152,902,406	20.0
TOTAL	322	\$18,612,889	\$216,428,884	11.6

⁵ Each division has FTE dedicated to compliance and audit activities. Each division has identified audit and compliance FTE using an FTE roster report generated from Information Access (IA) warehouse for FY 2001.

⁶ Expenditures related to audit and compliance activities include FTE salaries and benefits listed in the roster report for FY 2001.

⁷ The methodology for estimating the collections baseline as of FY 2001 for each tax type is as follows:

Sales and Use Tax. The estimated baseline for collections consists of an average of collections data over three fiscal years (FY 1999 to FY 2001). The estimated baseline for collections is derived from taxpayer payments and data from the sales and use tax section's compliance report. Actual taxpayer payments for FY 2000 and FY 2001 were determined by looking up net amounts in the taxpayer accounting system (TPA). Taxpayer payments for FY 1999 were determined by first calculating the percentage of FY 2000 and FY 2001 assessment of tax, penalty and interest that were paid by taxpayer payments. For FY 2000 and FY 2001 those percentages were 47.46% and 42.31% respectively. The average of the FY 2000 and FY 2001 percentages, 44.89% was then applied to FY 1999 assessments of tax, penalty and interest to arrive at FY 1999 taxpayer payments of \$14,876,276.

Corporate Tax. The estimated baseline for collections is based on an average of collections data over three fiscal years (FY 1999 to FY 2001). The data in this calculation include: additional tax audits, over assessment audits, nexus payments, and claims denied. Additional tax audit data is derived from the taxpayer accounting system and from the corporation inventory system.

Individual Income Tax. The estimated baseline for collections consists of a rolling average of collections data over three fiscal years (FY1999 to FY 2001) from income tax division audits for payments received during the proposal period. The baseline collection data for income tax also includes amounts received from non current return payments, and payments received during the proposal period. MCE is credited with payments made after the proposal period, as well as and refunds applied. For FY 2000-2002, \$21.6 million has been paid during the proposal period and \$53.9 million after the proposal period.

MCE. The MCE baseline consists of the total collections for FY 2001. The data for the baseline is derived from the Computer Assisted Compliance System (CACS) system.

Explanation of the Results

The collection activity results achieved by non-filer and tax compliance FTE are reported through November 30, 2002. As of that date, the department has 88.42 FTE dedicated to the non-filer and tax compliance initiatives in FY 2003. Table 2 shows the number of FTE dedicated to each initiative by fiscal year. Each non-filer and tax compliance FTE must be trained and pass a probationary period before conducting compliance work. A significant portion of the compliance initiative work involves the audit process. Often in the audit process there is a time lag between the start of an audit and when the audit assessment is collected. After an audit has been completed the taxpayer is notified about their tax liability and ordered to pay.

Table 2.

Non-filer & Compliance FTE	FY 2002	FY 2003 to Date
Non-filer Initiative	13.84	17.17
Enhanced Tax Compliance Initiative	38.04	43.25
Enhanced Tax Compliance II Initiative	0	28.00
Total FTE	51.88	88.42

The gains from undertaking tax initiatives in terms of revenue raised are expected to be more significant as new employees gain experience and support systems are in place. As an example as shown in table 2.1, when the first report of the non-filer and tax compliance initiative was submitted to the legislature in January 2002, the overall ratio of collections to expenditures for these initiatives was 6 to 1. In other words, it is estimated that \$6 dollars in revenue is collected for each \$1 spent. This ratio from January 2002 shows less return on investment when compared to the department's FY 2001 baseline ratio of 11.6 to 1. The ratio is low in January 2002 because this time period (July 2001 to December 2001) reflects a period when hiring, training issues and audit assessment work had not fully been completed causing lags in revenue collection.

The overall ratio of collections to expenditures is 10.8 to 1 as of November 2002. Now that the department has made the investments necessary to support these activities, the revenue gains generated from these activities should continue to grow.

Table 2.1

Ratio of Collections to Expenditures	FY 2001 DOR Baseline	Ratio (Coll: Exp) as of Jan 2002	Ratio (Coll: Exp) as of Nov 2002
Non-filer Initiative	Not App	5.1	12.4
Tax Compliance Initiative	Not App	6.4	11.0
Tax Compliance II Initiative	Not App	Not App	6.4
Total	11.6	6.0	10.8

FY 2002-03 Biennium Year-to-Date Performance Results

This report contains required performance results data on the following:

- (1) non-filer initiative including the federal off-set program of Minnesota state taxes;
- (2) tax compliance initiative; and
- (3) tax compliance II initiative.

The report period reflects activity from July 2001 through November 30, 2002 Biennium-to-date referenced in this report reflects the same time period, of July 2001 through November 30, 2002.

Non-Filer Initiative, including Federal Off-set Program

The department was appropriated funding in the FY 2002-03 biennium to identify and collect tax liabilities from individuals and businesses that currently do not pay 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. Taxpayer ignorance and willful disregard for the law may cause non-filing by individuals and businesses. Several methods are used to locate taxpayers who do not file, such as:

- Data provided by the Internal Revenue Service (IRS);
- Verification of income by Minnesota taxpayers on their federal returns;
- Data exchanges with other state agencies; and
- Review of newspapers, periodicals, websites and annual reports to identify unreported business activity.

In the individual income tax area, a criminal investigator has been hired to pursue individual income tax fraud and several collectors have been added to pursue collections from uncooperative taxpayers who refused to file returns and have been assessed liabilities based on information researched by the individual income tax division.

In the sales and use tax and corporate tax areas, non-filing businesses and corporations include nexus cases. Auditors hired for this initiative review nexus cases involving out-of-state businesses and corporations that have presence in Minnesota but are not filing and paying taxes owed.

Another component of the non-filer initiative is the federal off-set recapture program. The overall federal off-set program, which off-sets includes most type of payments made by the federal government, is called the Treasury Off-set program (TOP). As a part of the TOP program process, the department refers state tax debt to FMS for recapture using a Computer Assisted Compliance (CACS) system to identify taxpayers using a debt criterion⁸. If a taxpayer meets this debt criterion, Minnesota state tax debt will be automatically deducted from an IRS refund prior to distributing these federal funds to the taxpayer.

Federal offset collection activity of Minnesota state taxes occurs throughout the year and peaks during the months of March and April. A total of 70,672 cases, representing \$180 million of associated debt, were referred to FMS. Of the total cases referred, a net total of 5,889 cases were offset with \$2,539,096 of net revenue collected from the program and sent to the general fund.

Table 3.0

FY 2002-03 Biennium-to-Date Non-filer Initiative Collection Results

Tax Type	FTE (FY 03 Only)	Gen Fund Expenditures	Actual Collections	Target	Results to Date
MCE (including Federal Offset Program)	5.0	\$492,131	\$11,821,725	\$10,400,000	100% Achieved
Individual Income Tax	1.63	\$118,902	Not Applicable	Not Applicable	Not applicable
Sales&Use/ Corp Tax	9.99	\$606,759	\$5,397,113	\$9,670,000	56% achieved
Other ⁹	.55	\$167,359	Not Applicable	Not Applicable	Not applicable
Total	17.17	\$1,385,151	\$17,218,838	\$20,070,000	86% achieved

⁸ The CACS system is used to identify taxpayers meeting a debt criteria. The debt criteria includes the following: (1) debt is not over 10 years old; (2) debt is more than or equal to \$25; (3) debt is for individual income tax; (4) debt is not hold coded or on hold due to appeal or adjustment; (5) debt is at least 6 months old; (6) debt is not in bankruptcy; (7) excludes certain CACS functions in a billing cycle. Certified letters are sent to taxpayers about the possibility of an offset occurring against their federal tax refund for recapture of state taxes. Taxpayers are given 60 days to respond.

⁹ Other includes sales and use tax gap study expenditures and appeals and legal division expenditures.

Table 3.0 summarizes the FY 2002-03 biennium year-to-date results for the total revenue collected from individuals, business, corporate tax non-filers and the federal recapture program. The total dollars collected by MCE from individual income tax non-filers are from the assessment of taxes owed including penalty and interest. Dollars collected from businesses and corporations include assessments paid by the taxpayer and taxes reduced by claims denied.¹⁰ Through November 2002 (the FY 2002-03 biennium is 70.8% completed), the total revenue collected from the non-filer initiative and deposited into the general fund is \$17,218,838. By the close of FY 2003, the department expects to collect the amount targeted in legislation for this initiative.

As a part of these compliance initiatives, the department must also report its biennium-to-date performance resolving taxpayer cases and bringing corporations and businesses into the tax system. The number of individuals non-filer cases resolved pertains to cases concluded with Commissioner Filed Returns (CFR), tax orders in lieu of CFR's, or by the taxpayer filing one or more returns in response to a demand to file. For the FY 2002-03 biennium year-to-date, individual income tax auditors hired with initiative funding have resolved a total of 561 individual non-filer cases.

The number of businesses brought into the sales tax system are tracked according to the number of businesses registered for sales and use tax as a result of nexus/non-filer investigations. Similarly, the number of corporations brought into the corporate tax system is tracked according to the number of nexus/non-filer investigations. For the FY 2002-03 biennium year-to-date, a total of new 309 businesses and corporations have been brought into the tax system as a result of the compliance initiatives.

¹⁰ For corporate and sales tax, assessments are defined as corporate and sales tax plus penalty and interest plus claims denied. A claim denied is the denial of a refund claim initiated by the taxpayer.

Tax Compliance Initiative

The purpose of the tax compliance initiative is to increase audit and collection activity in the income tax, sales tax and corporate tax areas.

Audit and collection methods for taxpayers that are furthest from compliance include:

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

As of FY 2002-03 YTD (with 70.8% of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is \$36,335,679. The total revenue collected to date exceeds the targeted amount to be collected for the FY 2002-03 biennium. Table 4.0 summarizes expenditure data and the total revenue collected for each tax type.

Table 4.0

FY 2002-03 Biennium-to-Date Tax Compliance Collection Results

Tax Type	FTE (FY 03 only)	Gen Fund Expenditures	Actual Collections	Target	Results to Date
Sales & Use/					
Corp Tax	20.65	\$1,609,443	\$11,640,139	\$8,075,000	100% achieved
Income Tax ¹¹	4.04	\$246,664	\$520,905	\$1,328,000	39% achieved
MCE	18.56	\$1,446,259	\$24,174,635	\$23,000,000	100% achieved
TOTAL	43.25	\$3,302,366	\$36,335,679	\$32,403,000	100% achieved

¹¹ Note: \$9 million has been assessed and MCE is pursuing collection.

Tax Compliance II

The 2002 Legislature allocated additional funding to the department to restore \$5 million in budget cuts to the department's tax compliance activities to avoid a projected \$14 million revenue loss, and to pay for the cost of more tax compliance initiatives. This additional funding provided for FY 2003 is referred to as the Tax Compliance II initiative. This funding will be used to identify and collect tax liabilities from individuals and businesses that currently do not pay all taxes owed and to increase audit and collection activity in the income, sales and corporate tax as well as lawful gambling and insurance tax areas. Funding for this initiative has also allowed the department to hire additional tax collectors within the Minnesota Collections Enterprise (MCE) to more actively pursue delinquent taxpayers.

Also as a part of this initiative, the Individual income tax division will begin comparing income reported on federal form K-1 with income listed on state individual income tax returns of non-residents to determine if the income from partnerships and S-Corporations was accurately reported on Minnesota income tax returns. Data for this K-1 project first became available to the department in September 2002 after the IRS started notifying states about the amount of earnings distributed to non-residents of Minnesota from partnerships and S-Corporations with a Minnesota address. Approximately two thousand demand notices will be mailed in January 2003. Results from this effort will be available soon.

Through November 2002 (FY 2003 is 41.7% completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is \$3,784,536. Table 5 shows how the department has achieved 50% of the targeted amount it needs to collect for the biennium. The department fully expects to collect the amount targeted in legislation by the end of FY 2003.

Table 5.

FY 2002-03 Biennium-to-Date Compliance Collection Results

Tax Type	FTE	Gen Fund (FY 03 only)	Actual Expenditures	Target Collections	Results to Date
Sales/Corporate	9.34	\$195,993	\$995,278	\$1,987,000	50% Achieved
Special	2.72	\$40,625	\$184,019	\$450,000	41% achieved
Income	4.35	\$64,904	\$25,595	\$1,700,000	2% achieved
MCE	10.51	\$255,434	\$2,579,644	\$3,500,000	74% achieved
Other ¹²	1.08	\$25,923	Not Applicable	Not Applicable	
Total	28.0	\$582,879	\$3,784,536	\$7,637,000	50% achieved

¹² Other represents appeals and criminal investigation expenditures.

Looking Forward

The expected outcomes from the non-filer and tax compliance initiative include increased revenue and improved compliance with the tax laws. Table 6 shows that through the end of November 2002, the department has collected \$57 million for the FY 2002-03 biennium. By the close of FY 2003, the department fully expects to collect the amount targeted in legislation for each initiative.

Table 6.

FY 2002-03 Biennium Year-to-Date Summary Results

	% of Gen Fund Appropriation Expended	Actual Collections	Target	Results to Date
Non-filer Initiative	69.4%	\$17,218,838	\$20,070,000	86% Achieved
Tax Compliance	63.9%	\$36,335,679	\$32,403,000	100% Achieved
Tax Compliance II	22.7%	\$3,784,536	\$7,637,000	50% Achieved
TOTAL	54.2%	\$57,339,053	\$60,110,000	95% Achieved

Before the department could start tracking revenue collection from compliance work, the department successfully hired and trained staff positions and developed manual/automated collection tracking systems for each tax type. With these components now in place for the FY 2004-05 biennium, the department will have more capacity to focus its resources on the collection of revenue from these compliance activities. The department is assessing its ability to develop a universal and automated data collections system that could be utilized by all tax types for reporting revenues collected from compliance work. Such a system would significantly improve the department's reporting efficiency allowing more resources for compliance work and less for administration.