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Expanded Tax Compliance Initiatives

FY 2004–2005

Report to the Minnesota Legislature

March 2004

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To Minnesota Legislators:

This is the first of two reports on the Department of Revenue's progress toward generating \$59.8 million in the 2004-05 biennium through increased tax enforcement activities. As you know, the department received \$12.9 million to collect that amount.

(These initiatives were authorized by the legislature under Laws of Minnesota 2003, First Special Session, Chapter 1, Article 1, Section 15, subdivision 2.)

As of December 31, the end of the first quarter of the biennium, the department had collected \$16.6 million, or 28 percent, of the anticipated \$59.8 million. Based on this result, the department expects to exceed the goal of \$59.8 million. The results to date include:

- \$10.7 million from the collection of unpaid taxes; and
- \$5.9 million from audits of businesses and individuals.

The cost of collecting this \$16.6 million was \$1.6 million. In other words, each dollar spent on expanded tax enforcement brought in \$10 in revenue.

The department obtained similar results through expanded enforcement activities in the 2002-03 biennium. The department was appropriated \$9.7 million to collect about \$60 million in added revenue from tax evaders and delinquent payers. The actual amount collected climbed to \$97.2 million, or \$32.7 million more than anticipated — which generated \$10 in added revenue for each \$1 appropriated.

The activities described in this report are 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

**Laws of Minnesota 2003, First Special Session,
Chapter 1, Article 1, Section 15, Subdivision 2.**

**Minnesota Department of Revenue
600 North Robert Street
St. Paul, Minnesota 55146
651-556-4044
www.taxes.state.mn.us**

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Summary of Findings

Minnesota Legislation appropriated \$12.8 million to the Department of Revenue for the 2004-05 biennium to collect \$59.8 through expanded tax compliance activities. This report summarizes the results the department has achieved as of December 31, 2003, the first six months of the biennium. During this period — the first quarter of the biennium — the department has:

- Collected and deposited in the general fund \$16.6 million, or 27.8 percent, of the anticipated \$59.8 million sought through the tax compliance initiatives.
- Resolved a total of 2,907 noncompliant individual income tax cases.
- Identified a total of 103 taxpayers non compliant with the sales and use tax system and 165 taxpayers noncompliant with the corporate tax system.

To collect the \$16.6 million to date, the department spent \$1.6 million, or approximately \$1 dollar for every \$10 collected. The department expects to meet or exceed the goal of generating \$59.8 million for the biennium through the tax compliance initiatives authorized by the legislature.

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 2004-2005 tax compliance initiative. 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. As a result, 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. The cost of preparing the report is estimated at \$550.

Purpose of this Report

This is the first of two reports by the department for the FY 2004-05 biennium that provides mandatory performance indicator results in accordance with Laws of Minnesota 2003, First Special Session, chapter 1, article 1, section 15, subdivision 2.

For the FY 2004-05 biennium, the department was appropriated \$12.8 million from the general fund¹ 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 \$59.8 million by the end of the biennium.

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

- Estimated FY 2002 baseline expenditures and full-time equivalent (FTE)² information related to the department's compliance and audit activities.
- FY 2004 year-to-date expenditures and FTE information related to the tax compliance initiative.
- The number of taxpayers noncompliant with the corporate tax system and the percentage and dollar amounts of valid tax liabilities collected.
- The number of taxpayers noncompliant with the sales and use tax system and the dollar amounts of valid tax liabilities collected.

¹ During the FY 2002-03 biennium, the 2001 Legislature appropriated \$7.672 million in FY 02-03 for the nonfiler 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. Laws of Minnesota 2002, chapter 377, article 12, section 17, paragraph A.

² Minnesota statute § 16A.122 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.

- The number of individual income tax noncompliant cases resolved and the dollar amounts of valid tax liabilities collected.

The report covers the department's performance related to these indicators in detail. The indicators discussed are for the FY 2004-05 initiative which is also referred to as the "expanded tax compliance" initiative in this report.

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 and use, corporate franchise, petroleum, environmental, gambling, cigarette and tobacco, alcohol, and insurance. The department collects approximately \$13.7 billion per year in state revenues.

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 initially received funding to increase the level of compliance with tax laws during the FY 2002-03 biennium³. Although the vast majority of taxpayers voluntarily comply with the tax laws, the focus of the tax compliance initiative is on taxpayers that do not voluntarily file, pay or comply with the tax laws. It is expected that previous and current tax compliance initiatives will continue to have several positive outcomes such as a fairer tax system and increased revenue for Minnesota.

Compliance and Audit Activities Baseline Information

The type of compliance and audit activities conducted by the department to pursue noncompliant taxpayers includes, but is not limited to: (1) audits of taxpayer filings to correct errors and detect abuse; (2) identifying taxpayers who should file, but did not ("nonfilers") and identifying unreported taxable activity; and (3) collection activities on delinquent accounts. These activities directly relate to one of the department's strategic goals, which is to focus on taxpayers that are furthest from compliance.

As required, the department has estimated baseline information for its compliance and audit activities for FY 2002. The baseline information reported in Table 1.0. shows the revenues produced from compliance and audit activities from major tax types administered within the department. Baseline revenues for individual income tax, sales and use tax, and corporate tax have been estimated using a rolling average of revenues from compliance related activities from FY 2000 to FY 2002. Baseline revenues for the department's Collections Division, on the other hand, are not computed using a rolling average but rather are based on actual collections from the Computer Assisted Compliance (CACs) System for FY 2002.

³ As stated in legislation, the nonfiler and tax compliance initiatives were expected to result in \$60.1 million of new general fund revenues for the biennium ending June 30, 2003.

Table 1.0. FY 2002 Estimated Baseline for Compliance Activity Revenues⁴				
Tax Type/Function	FTE	Estimated Compliance Revenues	Estimated Expenditures	Ratio (Rev:Exp)
Collections	142	\$155,382,000	\$8,283,504	18.8
Individual Income Tax	47	\$7,922,000	\$2,789,068	2.8
Withholding	9	\$263,000	\$496,798	.5
Sales & Use/Corporate Taxes	144	\$68,129,000	\$9,529,059	7.2
Special Taxes	32	\$880,000	\$2,044,164	.4
TOTAL⁵	374	\$232,576,000	\$23,142,593	10.0

Dollars collected from baseline compliance related activities are tracked separately from the payments received as a result of the tax compliance initiative efforts. The department has a rigorous system in place to ensure that payments are not double-counted among divisions internally or double-counted in either the baseline revenues or tax compliance initiative revenues.

⁴ The methodology for estimating the revenues baseline from compliance related activities as of FY 2002 for each major tax type is as follows:

Sales and Use Tax. The estimated baseline for revenues consists of a rolling average of collections data from compliance activities limited to field and managed audits over three fiscal years (FY 2000 to FY 2002). The estimated baseline for revenues is derived from actual taxpayer payments and data from the sales and use tax section's compliance report and it includes actual payments from field and managed audits collected within 90 days of the order period. Dollars received from field and managed audits include claims denied, remaining claims applied, interest paid on claims allowed that was applied. Actual taxpayer payments were determined by looking up net amounts in the taxpayer accounting system (TPA). This information from TPA was transferred to the compliance report used by the section.

Corporate Tax. The estimated baseline for revenues is based on a rolling average of collections data over three fiscal years (FY 2000 to FY 2002). The data in this calculation include: additional tax audits, over assessment audits, nexus payments, and an average of 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 revenues consists of a rolling average of collections data over three fiscal years (FY 2000 to FY 2002) 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 refunds applied.

⁵ The FY 2002 total baseline is inclusive of most tax types/functions within the department that are currently receiving funding from FY 2004-05 enforced tax compliance initiative. The tax operations function has been excluded from the total FY 2002 baseline because of system limitations in tracking revenues from early audit returns. These limitations are expected to be resolved and will be reported in the next required report due January 2005.

The department's FY 2001 baseline for revenues from compliance activities was \$216,428,884 as reported in January 2003. Unlike the FY 2002 baseline, the FY 2001 baseline was limited to expenditures and revenues from individual income tax, sales and use tax, corporate tax and collections.

Explanation of the Results

The year-to-date tax collections that resulted from the full-time equivalent (FTE) employees assigned to the initiative are reported through December 31, 2003. As shown in Table 2.0., there are currently 60 FTE for this initiative in FY 2004. Each FTE funded from the tax compliance initiative spends six to twelve months in training before becoming proficient in conducting compliance work. As such, there may be an initial lag in compliance revenue collection as a result of implementation efforts such as training.

Table 2.0 Tax Compliance Initiative FTE	FY 2004 to date (actual)	FY 2004-2005 planned
Total FTE	60	133

The current overall ratio of collections to expenditures is 10 to 1 as of December 31, 2003. The rate of return from this initiative is expected to improve once this new initiative is fully implemented. As reported in January 2003, the gains from undertaking tax compliance initiatives in terms of revenue raised are expected to be more significant as new employees gain experience and learn to operate existing systems in place that support the department's compliance improvement efforts.

FY 2004-05 Biennium Year-to-Date Performance Results

This report contains required performance results data on the current initiative for the period covering July 2003 to December 2003. Biennium-to-date results referenced in this report reflect the same report period of July 2003 to December 31, 2003.

Expanded Tax Compliance Initiative

The purpose of the expanded tax compliance initiative is to generate additional revenue by increasing audits and collections of income tax, sales tax and corporate tax, insurance tax, gambling tax and withholding tax.

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

Collection Activities:

- Written notices, telephone and in-person contacts, seizures of real and personal property, and levies on financial assets of noncompliant taxpayers.
- Field investigations and field surveillance.
- Revocations and license clearance hearings.

Business Compliance Activities:

- Identifying and registering out-of-state businesses that are required to collect and remit sales and use taxes.
- Identifying out-of-state corporations and partnerships that should be paying corporate taxes.
- Conducting audits in specific areas where noncompliance has been identified.
- Targeting audits to types of businesses with a history of noncompliance (for example, cash businesses and independent contractors).

Individual Income Tax Compliance Activities:

- Identifying nonfilers and under-reporters particularly among the self-employed.
- Auditing under-reporters.
- Identifying individuals living in Minnesota who are claiming residency in states which do not impose income tax.
- Identifying tax adjustments in early audit activities so that refunds for taxpayers are adjusted before they are issued.

Through the end of December 2003 (with 25% of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is \$16.6 million. Table 3.0. provides detailed data related to expenditures and the total revenues collected for each tax type from this initiative. The department fully expects to collect the amount targeted in legislation by the end of FY 2005.

Tax Type/Function	FTE (FY04 only)	Gen Fund Expenditures	Actual Compliance Collections	Biennium Target	% of Target Achieved
Collections	25.5	\$765,195	\$10,767,154	\$32,887,000	32.7%
Individual Income Tax	8.3	\$199,829	\$705,673	\$6,371,000	11.1%
Withholding	4.0	\$90,129	\$1,035,214	\$2,295,000	45.1%
Sales & Use/Corp Taxes	17.0	\$444,764	\$2,683,535	\$16,282,000	16.5%
Special Taxes	1.8	\$31,772	\$1,437,671	\$1,001,000	143.6%
Tax Operations ⁶	0	\$0	\$0	\$1,002,000	0%
Other ⁷	3.4	\$93,917	NA	NA	NA
TOTAL	60.0	\$1,625,606	\$16,629,247	\$59,838,000	27.8%

⁶ For the Tax Operations division, expenditures and revenues generated related to the tax compliance initiatives will occur on a seasonal basis during the income tax filing period. As such, revenues and expenditures will start taking place beginning in January 2004.

⁷ In table 3.0., the function "Other" refers to expenditures within the Appeals and Criminal Investigation Divisions.

To improve compliance overall, noncompliant taxpayers must be identified and noncompliant cases must be resolved. Table 3.1. shows the number of individual income tax noncompliant cases resolved and the number of taxpayers that are not in compliance with the sales and use and corporate tax laws.

In the area of individual income tax, the number of noncompliant taxpayer cases resolved as a result of the tax compliance initiative is 2,907. An individual income taxpayer case is resolved if the following occurs:

- The auditor files a return for a nonfiling taxpayer; or
- The auditor is able to get the nonfiling taxpayer to file a return;
- The auditor completes an audit report. This audit report may indicate a balance due or refund or that there is no change.

The “noncompliant” criteria are slightly different for businesses and corporations. They are identified as noncompliant with the tax laws if the audit or other compliance actions result in a change in taxpayer liability. A business or corporation is not counted as being noncompliant with the business tax laws when the audit or other compliance actions result in “no change” to the taxpayer liability.

	Non Compliant Cases “Identified” FY 2004 to date	Non Compliant Cases “Resolved” FY 2004 to Date
Individual Income Tax System	-----	2,907
Sales and Use Tax System	103	-----
Corporate Tax System	165	-----
TOTAL⁸	268	2,907

⁸ This total excludes taxpayers noncompliant with the withholding tax system. The Withholding Tax division has identified 652 taxpayers as noncompliant with the withholding tax system as result of the tax compliance initiative. The criteria for a taxpayer being identified as noncompliant with the withholding tax system is as follows:

- a. Withholding income tax but not remitting it;
- b. Withholding income tax, but not depositing it in a timely manner; or
- c. Not withholding income tax when they should have.

Looking Forward

The expected outcomes from the current initiative include increased revenue and improved compliance with the tax laws. Table 4.0 shows that through the end of December 2003, the department has collected \$16.6 million for the FY 2004-05 biennium. By the close of FY 2005, the department fully expects to collect the amount targeted in legislation for this initiative.

	% of General Fund Appropriation Expended	Actual Collections	Target	% of Target Achieved
Expanded Tax Compliance Initiative	12.6%	\$16.6M	\$59.8M	27.8%

The department is developing a plan to build more robust data warehouses and more powerful analytical software applications for use in compliance activities. The department's plan assesses the adequacy of current data warehouses and the sufficiency of current tools to analyze the data. In addition, the plan makes recommendations for future incremental investments in data warehouse resources and analytical software. The department is now exploring options for funding the plan. Its first priority is to improve the audit selection process and the management of audit cases. Ultimately, the department's goal is to create highly sophisticated analytical tools for use in tax compliance activities as well as for advanced fiscal analysis, revenue forecasting and financial reporting activities.

In addition, the department is evaluating the results it achieved from the current compliance initiative in the first six months of this biennium. This evaluation should reveal the extent to which the department may recommend the undertaking of added compliance initiatives. That recommendation will depend on the ability of the department to continue to generate a high rate of revenue for each dollar spent and the ability to keep its current infrastructure intact to support that effort.